

University of Nebraska - Lincoln

DigitalCommons@University of Nebraska - Lincoln

---

College of Law, Faculty Publications

Law, College of

---

2000

## Expanding the Non-Transactional Revolution: A New Approach to Securities Registration Exemptions

C. Steven Bradford

*University of Nebraska-Lincoln*, sbradford1@unl.edu

Follow this and additional works at: <https://digitalcommons.unl.edu/lawfacpub>



Part of the [Legal Studies Commons](#)

---

Bradford, C. Steven, "Expanding the Non-Transactional Revolution: A New Approach to Securities Registration Exemptions" (2000). *College of Law, Faculty Publications*. 70.

<https://digitalcommons.unl.edu/lawfacpub/70>

This Article is brought to you for free and open access by the Law, College of at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in College of Law, Faculty Publications by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.

# EMORY LAW JOURNAL

---

Volume 49

SPRING 2000

Number 2

---

## ARTICLES

### EXPANDING THE NON-TRANSACTIONAL REVOLUTION: A NEW APPROACH TO SECURITIES REGISTRATION EXEMPTIONS

*C. Steven Bradford\**

INTRODUCTION .....	439
I. THE TRANSACTIONAL NATURE OF THE REGISTRATION REQUIREMENT .....	442
II. AN INTRODUCTION TO THE TRANSACTION EXEMPTIONS .....	448
A. <i>Small Offering Exemptions</i> .....	448
B. <i>Sophisticated Offeree Exemptions</i> .....	451
C. <i>Deference Exemptions</i> .....	452
D. <i>The Intrastate Offering Exemption</i> .....	453
III. THE TRANSACTIONAL BASIS OF EXEMPTIONS FROM THE REGISTRATION REQUIREMENT .....	455
A. <i>Resale Restrictions</i> .....	456
1. <i>Introduction to the Underwriter Concept                 and Limits on Resales</i> .....	456
2. <i>Liberalization: Easing the Transactional                 Limits on Resales</i> .....	458
B. <i>The Integration Doctrine</i> .....	460
1. <i>An Introduction to the Integration Doctrine</i> .....	460
2. <i>Liberalization: Changes to the Integration Doctrine</i> .....	464

---

\* Cline, Williams, Wright, Johnson & Oldfather Professor of Law, University of Nebraska College of Law. This Article was funded in part by a Ross McCollum Summer Research Grant. My thanks to Jessica Feller, University of Nebraska College of Law Class of 1998, and to Colleen Timm, University of Nebraska College of Law Class of 2001, for their research assistance on this Article.

IV. THE DILEMMA POSED BY THE CURRENT SYSTEM ..... 467

    A. *The Problem with the Integration Doctrine* ..... 468

    B. *The Safe Harbors as an Incomplete Solution*..... 470

    C. *The Problem with Abolishing the Integration Doctrine Entirely*..... 472

V. RESOLVING THE DILEMMA: A WEIGHTED EXEMPTION SYSTEM ..... 473

    A. *Using Multiple Small Offering Exemptions*..... 474

    B. *Dealing with the Sophisticated Offeree and Deference Exemptions*..... 478

        1. *Sophisticated Offeree Exemptions*..... 479

        2. *Deference Exemptions*..... 480

VI. POTENTIAL PROBLEMS WITH THE WEIGHTED EXEMPTION APPROACH..... 480

    A. *Restrictions on Solicitation*..... 481

    B. *Restrictions on Resale* ..... 483

    C. *Limits on the Number of Purchasers*..... 484

CONCLUSION..... 485

\* \* \*

## INTRODUCTION

Federal securities law is in the midst of a revolution. Since 1933, the registration of securities offerings under the Securities Act of 1933<sup>1</sup> (the "Securities Act") and the exemptions from the registration requirement have rested on the elusive metaphysical, almost mystical, concept of "transaction." Offers and sales of securities are grouped into discrete transactions known as offerings or issues, and the provisions of the Securities Act apply to those offerings collectively. Application of the registration requirement, the exemptions from the registration requirement, and resale restrictions depend on the characteristics not of individual offers and sales but of the offering as a whole. The transactional system has three foundational elements: (1) *current registration of discrete offerings*—the idea that an issuer may register only discrete offerings of securities planned to be sold in the immediate future; (2) *resale restrictions arising out of the underwriter concept*—the idea that securities acquired in an exempted offering are not freely resalable; and (3) *the integration doctrine*—the idea that an entire offering, not individual offers and sales, must qualify for a single exemption from registration.<sup>2</sup>

That transactional foundation is crumbling rapidly. Unfortunately, the changes have not been uniform across all three elements of the system. The parts of the system most important to small businesses have changed the least, leaving them at a competitive disadvantage.

With respect to registration, the Securities and Exchange Commission ("SEC") has dramatically expanded its shelf registration rule, allowing more securities to be registered and then sold from time to time as needed rather than in an immediate, one-time transaction.<sup>3</sup> In 1996, the Advisory Committee on the Capital Formation and Regulatory Processes, chaired by then-Commissioner Steven Wallman, issued a report recommending that the transactional basis of Securities Act registration be virtually eliminated for some issuers and weakened for others.<sup>4</sup> The SEC responded with a rules proposal, known as the "Aircraft Carrier" because of its size, that does not fully accept the Advisory

---

<sup>1</sup> 15 U.S.C. § 77a-aa (1994).

<sup>2</sup> Antifraud liability under the federal securities law is also fundamentally transaction-based. See Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567 (1997).

<sup>3</sup> See 17 C.F.R. § 230.415 (1999).

<sup>4</sup> See Securities & Exchange Comm'n, *Report of the Advisory Committee on the Capital Formation and Regulatory Processes* (last modified July 24, 1996) <<http://www.sec.gov/news/studies/capform.htm>> ("Advisory Committee Report"); see also *infra* text accompanying notes 26-41.

Committee's recommendations, but nevertheless eliminates some of the burdens of the current transactional registration system, particularly for larger companies.<sup>5</sup>

Similar changes have been made to the restrictions on resale. In 1972, the SEC adopted a resale safe harbor, Rule 144, that made resale restrictions more certain.<sup>6</sup> The SEC has gradually liberalized Rule 144 over the years to weaken the tie between resales and the transaction in which the securities were originally offered.<sup>7</sup> In 1990, the SEC adopted the Rule 144A resale safe harbor, which seems to cast aside the transaction idea altogether.<sup>8</sup>

The third element of the transactional system—exemptions from registration—hinges on the integration doctrine, which is used by the SEC to determine which offers and sales of securities fall within a single transaction.<sup>9</sup> The changes to the integration doctrine have been less drastic than in the other two areas. The SEC has added safe harbors to protect particular exemptions against integration,<sup>10</sup> but there is no unified, broadly applicable integration safe harbor equivalent to the Rule 144 resale safe harbor. Neither the SEC nor any group affiliated with the SEC has proposed broad deviations from the transaction concept similar to those contained in Rule 144A or the Advisory Committee's proposals. An internal Task Force on Disclosure Simplification appointed by the SEC to examine the exemptions from registration proposed only relatively minor modifications to the exemptions, not a frontal attack on the transaction system itself.<sup>11</sup>

This is unfortunate, because the exemptions from the registration requirement are the most important part of the Securities Act for small businesses. Economies of scale make Securities Act registration disproportionately

---

<sup>5</sup> The Regulation of Securities Offerings, Exchange Act Release No. 7606A, 63 Fed. Reg. 67,174 (1988) (proposed Dec. 4, 1988) ("Aircraft Carrier"); *see also infra* text accompanying notes 45-54.

<sup>6</sup> 17 C.F.R. § 230.144 (1999). *See* Definition of the Terms "Underwriter" and "Brokers' Transactions," Exchange Act Release No. 5223, 37 Fed. Reg. 591 (1972) (original adoption of Rule 144). *See also infra* text accompanying notes 138-43.

<sup>7</sup> *See infra* text accompanying notes 144-48.

<sup>8</sup> 17 C.F.R. § 230.144A (1999). *See* Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Exchange Act Release No. 6862, 55 Fed. Reg. 17,933 (1990) (adopting Rule 144A); *see also infra* text accompanying notes 149-54.

<sup>9</sup> *See infra* text accompanying notes 155-82.

<sup>10</sup> *See infra* text accompanying notes 183-91.

<sup>11</sup> *See* Securities & Exchange Comm'n, *Report of the Task Force on Disclosure Simplification* (last modified November 5, 1996) <<http://www.sec.gov/news/studies/smpl.htm>> ("Task Force Report"); *see also infra* text accompanying notes 192-97.

burdensome for smaller offerings and cost-effective only for larger public companies.<sup>12</sup> Yet, the greatest liberalization of the transaction concept is taking place in the registration system, not the exemptions. The transaction restriction has changed the least in the exemptions from registration, which benefit small businesses the most.<sup>13</sup> Although the integration doctrine affects both large and small issuers, "the tangles and snares of the doctrine generally are less troublesome to larger issuers," who have a variety of financing alternatives.<sup>14</sup> The capital needs of smaller, emerging businesses are difficult to predict, leading to multiple rounds of financing that are more likely to ensnare them in the integration doctrine.<sup>15</sup> As a result, the benefits of the non-transactional revolution have been unfairly skewed in favor of larger issuers.

The transactional basis of the exemptions from registration stands virtually intact because no one has been able to resolve a fundamental dilemma. On one hand, the integration doctrine protects the policy bases of the registration exemptions. Abolishing the integration doctrine entirely would allow issuers to manipulate the system. If an issuer could split its offering among several different exemptions, offerings that should be registered might escape registration. On the other hand, the integration doctrine is costly and confusing to issuers using the transaction exemptions. Some offerings that do not fit within a single exemption nevertheless should be exempted. The SEC has been unable to resolve the dilemma—to find a way to protect the policy bases of the exemptions while accommodating the needs of small business issuers. As a result, the SEC has resorted to partial, Band-Aid fixes—individual integration safe harbors that alleviate some of the more egregious problems without resolving the basic dilemma.

It is time to rethink the entire transactional basis of the exemption system, much as the Advisory Committee rethought the transactional basis of the registration system. In this Article, I propose a weighted exemption system

---

<sup>12</sup> For a discussion of the economies of scale in registration, see C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591, 614-16 (1996).

<sup>13</sup> The liberalization of the resale restrictions applies to large and small companies alike. However, Rule 144A, the greatest challenge to the transaction concept in the resale area, is more likely to be used by larger companies because the qualified institutional buyers who are exempted by Rule 144A are less likely to buy the securities of small issuers. See Theresa A. Gabaldon, *Love and Money: An Affinity-Based Model for the Regulation of Capital Formation by Small Businesses*, 2 J. SMALL & EMERGING BUS. L. 259, 262 (1998) (noting that in many cases, investors in small businesses are relatives or friends of the promoters).

<sup>14</sup> Rutheford B. Campbell, Jr., *The Plight of Small Issuers (and Others) Under Regulation D: Those Nagging Problems That Need Attention*, 74 KY. L.J. 127, 162-63 (1985-86).

<sup>15</sup> See Lyman Johnson & Steve Patterson, *The Reincarnation of Rule 152: False Hope on the Integration Front*, 46 WASH. & LEE L. REV. 539, 540 (1989).

that eliminates the transaction concept entirely, allowing an issuer to use more than one exemption for a single offering while preserving the integrity of the registration requirement and the policy bases of the exemptions. Under the proposed weighted exemption system, issuers could mix and match exemptions as they wish, subject to an overall dollar amount cap. To determine whether that cap has been met, the amount of securities sold using each exemption would be weighted in proportion to the amount of investor protection provided by that exemption.

I begin in Part I with a brief discussion of the transactional nature of the registration requirement. Part II introduces the various exemptions from registration and sketches their policy justifications. Part III discusses the transactional basis of the exemptions and the two doctrines that support that transactional system—restrictions on resale and the integration doctrine. In Part IV, I discuss the weaknesses of the integration doctrine and the dilemma the transactional system of exemptions presents. Part V presents my weighted exemption proposal, and Part VI discusses some potential problems with the weighted exemption proposal and their solutions.

No fundamental changes to the exemptions or to the SEC's philosophy of investor protection are required to implement a weighted exemption system. I will, therefore, take the existing exemptions as a given. My proposal can easily accommodate either the current exemptions or any amendments to those exemptions, with one *possible* exception—the restrictions on general solicitation in Regulation D.

## I. THE TRANSACTIONAL NATURE OF THE REGISTRATION REQUIREMENT

The Securities Act registration requirement is transactional in two senses. First, issuers must register an entire offering of securities; they cannot register part of an offering and seek an exemption for the other part. This is an aspect of the integration doctrine, to be discussed later.<sup>16</sup> Second, issuers may register only a single, discrete, identifiable offering. Except as discussed below, an issuer may not file a single registration statement and sell securities at various times as needed. The final sentence of section 6(a) of the Securities Act provides that “[a] registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered.”<sup>17</sup> The SEC has long

---

<sup>16</sup> See *infra* Part III.B.

<sup>17</sup> 15 U.S.C. § 77f(a) (1994).

interpreted this sentence to mean that an issuer may register only securities that it presently intends to offer for sale.<sup>18</sup> According to the SEC, "Congress contemplated that registration should be effective only in connection with offerings proposed to be made in the proximate future."<sup>19</sup> Furthermore, a Securities Act registration is effective only for the securities identified in the registration statement. If the issuer indicates in the registration statement that it intends to sell 100,000 shares of common stock and decides a month after that registration statement becomes effective to sell an additional 50,000 shares, a new registration is required.<sup>20</sup>

Despite the SEC interpretation of section 6(a), the SEC always has allowed some types of shelf registration—current registration of securities to be sold "off the shelf" at some indefinite time in the future.<sup>21</sup> In 1982, the SEC formalized and expanded its shelf registration policies in Securities Act Rule 415.<sup>22</sup> Rule 415 codified the traditional situations in which the SEC had allowed shelf registration,<sup>23</sup> but also added a significant new exception for certain public issuers.<sup>24</sup> Companies that qualify to use Rule 415 may register securities they plan to offer on a continuous or delayed basis over a period of up to two years.<sup>25</sup>

---

<sup>18</sup> See *United Combustion Corp.*, 3 S.E.C. 1062, 1063 (1938); *Shawnee Chiles Syndicate*, 10 S.E.C. 109, 113 (1941).

<sup>19</sup> *Shawnee Chiles Syndicate*, 10 S.E.C. at 113.

<sup>20</sup> See 17 C.F.R. § 230.413 (1999).

<sup>21</sup> See *Guides for the Preparation and Filing of Registration Statements*, Exchange Act Release No. 4936, 33 Fed. Reg. 18,617, 18,618 (1968), *rescinded in* Rescission of Guides and Redesignation of Industry Guides, Exchange Act Release No. 6384, 47 Fed. Reg. 11,476 (1982); Scott Hodes, *Shelf Registration: The Dilemma of the Securities and Exchange Commission*, 49 VA. L. REV. 1106, 1115-46 (1963); John Paul Ketels, *SEC Rule 415: The New Experimental Procedures for Shelf Registration*, 10 SEC. REG. L.J. 318, 323 (1983).

<sup>22</sup> 17 C.F.R. § 230.415 (1999). Rule 415 was adopted in March 1982 as a temporary rule effective until December 10, 1982. Its effective date was later extended to December 31, 1983, and a revised, permanent rule was adopted on November 10, 1983. See Francis J. Feeney, Jr., *The Saga of Rule 415: Registration for the Shelf*, 9 CORP. L. REV. 41, 44-47 (1986). For a more detailed discussion of the costs and benefits of Rule 415, see generally Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984).

<sup>23</sup> 17 C.F.R. § 230.415(a)(1)(i)-(ix) (1999); see also Feeney, *supra* note 22, at 42-44 (discussing shelf registration prior to Rule 415).

<sup>24</sup> See 17 C.F.R. § 230.415(a)(1)(x).

<sup>25</sup> See *id.* § 230.415(a)(2).



In February 1995, the SEC chartered the Advisory Committee on the Capital Formation and Regulatory Processes, chaired by then-SEC Commissioner Steven Wallman but otherwise consisting of outsiders.<sup>26</sup> The Advisory Committee's mission was

to assist the Commission in evaluating the efficiency and effectiveness of the regulatory process and the disclosure requirements relating to public offerings of securities, secondary market trading and corporate reporting, and in identifying and developing means to minimize costs imposed by current regulatory programs, from the perspective of investors, issuers, the various market participants, and other interested persons and regulatory authorities.<sup>27</sup>

The Advisory Committee issued its report in July 1996.<sup>28</sup> The Committee noted the "increasingly complex, but often ineffective, series of regulations and concepts fashioned over the years to preserve" the transactional registration requirements,<sup>29</sup> and proposed a company registration system that would almost fully integrate the periodic reporting requirements of the Exchange Act and the registration of offerings under the Securities Act.<sup>30</sup> The focus of the company registration system proposed by the Advisory Committee would be ongoing disclosure by issuers, rather than the occasional, transactional disclosure currently required by the Securities Act at the time of an offering. Continuous disclosure, not tied to any particular offering, would

---

<sup>26</sup> *Advisory Committee Report*, *supra* note 4, at 136-37. The Advisory Committee was originally chartered for one year, but its charter was extended for an additional seven months to allow it to complete its work. *Id.* at 138-39.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 1.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 22-29. The Advisory Committee proposed that certain non-routine and extraordinary transactions be treated differently. *Id.* at 25-26. Those special procedures are not discussed in the text.

The Advisory Committee's proposal was not the first company registration proposal. In 1966, Milton Cohen proposed a coordinated disclosure system focusing on the registration of companies. Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1366-1406 (1966). The American Law Institute's Federal Securities Code, proposed in 1980, similarly emphasized the registration of companies and de-emphasized the registration of particular offerings of securities. FEDERAL SECURITIES CODE (1980). The introduction to the Code indicated that "[u]nder the Code there will be no more registration of securities." *Id.* at introduction. Under the Federal Securities Code, a company would have been required to register when (1) it had \$1 million or more in assets and 500 or more securities holders, *id.* § 402; (2) when it made the first public distribution of its securities, *id.* §§ 403, 202(41); or (3) if any of its securities was traded on a national securities exchange, *id.* § 902(a)(1). An offering statement would still have been required for any distribution of securities. *Id.* § 502.

in essence provide an "umbrella" of disclosure under which offers and sales of securities could be made from time to time as needed.

Under the Advisory Committee's proposal, eligible companies would file a single Form C-1 registration statement disclosing their plan to sell securities from time to time in the future.<sup>31</sup> Companies would continue to file Exchange Act reports periodically as under the current system.<sup>32</sup> In most cases an issuer could sell its securities as needed with no additional SEC staff review.<sup>33</sup> The primary source of investor information would be the company's ongoing Exchange Act disclosure file, and, at the time of the sales, the issuer would have to file only material information concerning the specific offering and any material updates to the Exchange Act information already on file.<sup>34</sup> In "routine" transactions, the issuer would not even be required to deliver a formal prospectus to investors.<sup>35</sup>

The Advisory Committee's proposals focused on reporting, public companies rather than on small businesses.<sup>36</sup> The Advisory Committee concluded that the existing Securities Act structure was "well-suited for companies that are engaging in an initial public offering."<sup>37</sup> It left issues involving non-reporting companies and their use of the transaction exemptions to the SEC's Task Force on Disclosure Simplification.<sup>38</sup>

The Advisory Committee saw its company registration proposals as a virtual panacea. Issuers would see the benefits of company registration and

---

<sup>31</sup> *Advisory Committee Report*, *supra* note 4, at 22.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 22-23.

<sup>35</sup> *Id.* at 23-25. The Advisory Committee proposed three tiers of prospectus delivery requirements. Routine transactions (any offering not involving the sale of voting equity amounting to 20 percent or more of the issuer's existing public float) would be exempt. *Id.* at 23-25. The Committee indicated that 70 percent of all firm commitment common equity offerings in 1992-94 would have been routine. *Id.* at 24 n.23. Prospectuses would have to be delivered to non-accredited investors in "non-routine" transactions—offerings of voting equity amounting to 20 percent or more of the existing public float. *Id.* at 25. In "extraordinary" transactions—offerings of voting equity amounting to 40 percent or more of the existing public float—prospectuses would have to be delivered to non-accredited investors and the prospectus could not be used until after SEC review. *Id.* at 25-26.

<sup>36</sup> *Id.* at 8. The pilot company registration project proposed by the Advisory Committee is even more limited. The Committee proposed that participation initially be limited to companies with a \$75 million public float, two years of reporting under the Exchange Act, and a class of securities listed on a national securities exchange or traded on the NASDAQ National Market System. *Id.* at 28.

<sup>37</sup> *Id.* at 8.

<sup>38</sup> *See id.* at 11.

would choose to register rather than use the exemptions.<sup>39</sup> Once company registration was extended to smaller issuers, the problems the current transactional system causes small issuers would be resolved.<sup>40</sup> In fact, the Advisory Committee toyed with the idea of eliminating the transaction exemptions entirely.<sup>41</sup>

On July 25, 1996, the day after the release of the Advisory Committee report, the SEC issued a concept release seeking comment on the Advisory Committee's company registration proposal, as well as certain other disclosure issues.<sup>42</sup> The SEC received 55 comment letters responding to this release,<sup>43</sup> and late in 1998, it published its Aircraft Carrier rules proposal.<sup>44</sup>

The Aircraft Carrier did not fully adopt the Advisory Committee's company registration proposals, nor did it propose to eliminate the transactional basis of registration. In fact, the Aircraft Carrier proposals in some ways reemphasize the transactional focus of the existing system.<sup>45</sup> The Aircraft Carrier does, however, propose a couple of steps in the direction of company registration.<sup>46</sup> First, the proposals would allow some public companies to incorporate into their Securities Act registration statements some or all of the information in their Exchange Act periodic reports.<sup>47</sup> Some incorporation by reference has been allowed since the SEC's 1982 "integrated

---

<sup>39</sup> See *id.* According to the Advisory Committee:

The benefits resulting from registration, including the issuance of freely tradable securities in what otherwise would have been a private transaction resulting in restricted securities, should outweigh any additional costs imposed by registering the securities under the system. Illiquidity discounts typically imposed by the market on non-registered securities should be eliminated for all securities issued under the company registration system. . . . Also, issuers would ultimately benefit by the reduction or elimination of the costs and uncertainties that today result from complex interpretive concepts and the concomitant need to monitor transactions in restricted securities.

*Id.* at 29.

<sup>40</sup> See *id.* at 56.

<sup>41</sup> *Id.* at 100-02.

<sup>42</sup> Securities Act Concepts and Their Effects on Capital Formation, Exchange Act Release No. 7314, 61 Fed. Reg. 40,044 (1996).

<sup>43</sup> Aircraft Carrier, *supra* note 5, at 67,180.

<sup>44</sup> See *id.* The Aircraft Carrier fills more than 150 pages in the Federal Register and includes more than 650 footnotes. A full review of the Aircraft Carrier proposals is beyond the scope of this Article. For a good overview of the Aircraft Carrier proposals, see *Special Issue: The Aircraft Carrier Release*, INSIGHTS, Jan. 1999, at 2.

<sup>45</sup> See Linda C. Quinn & Otilie L. Jarmel, *SEC Communications Initiative: Welcome Reform or Regulatory Retrenchment?*, INSIGHTS, Jan. 1999, at 15.

<sup>46</sup> For a more detailed explanation, see Mark S. Bergman, *Proposed Reforms to the Securities Act Registration System*, INSIGHTS, Jan. 1999, at 4.

<sup>47</sup> Aircraft Carrier, *supra* note 5, at 67,181-83; 67,195-96.

disclosure" initiative,<sup>48</sup> but the Aircraft Carrier proposals would liberalize those incorporation-by-reference rules, further severing the tie between the disclosure requirements and the particular offering.<sup>49</sup> Second, the Aircraft Carrier proposes to allow some public companies, particularly larger issuers, to begin selling securities immediately upon filing the registration statement.<sup>50</sup> With these two changes, the registration system would begin to approach the umbrella disclosure, sell-at-any-time system contemplated by the Advisory Committee.

The Aircraft Carrier also contains a number of proposals that liberalize the current system's restrictions on communications.<sup>51</sup> Large public companies would be freed of almost all restrictions on communication prior to and during a registered offering.<sup>52</sup> The section 5 restrictions on communications prior to filing a registration statement would be liberalized for other companies, and most of the post-filing restrictions would be eliminated.<sup>53</sup> These communications proposals also move away from a strictly transactional view of registered offerings. Under the current system, what an issuer may say depends on whether the issuer is "in registration"—in other words, whether the issuer is engaged in an offering transaction.<sup>54</sup> Communications that would normally be acceptable are prohibited once an offering is in progress. Under the Aircraft Carrier communication proposals, the line between offering and non-offering would be less important to issuers, particularly large public issuers.

---

<sup>48</sup> Adoption of Integrated Disclosure System, Exchange Act Release No. 6383, 47 Fed. Reg. 11,380 (Mar. 16, 1982).

<sup>49</sup> Aircraft Carrier, *supra* note 5, at 67,181-83; 67,195-96.

<sup>50</sup> Aircraft Carrier, *supra* note 5, at 67,184; 67,196-97; see also Marilyn Mooney & Gillian McPhee, *Aircraft Carrier Proposals Change the Timing of the Registered Offering Process*, INSIGHTS, Jan. 1999, at 9.

<sup>51</sup> For a more detailed overview of the Aircraft Carrier's communications proposals, see generally Quinn & Jarmel, *supra* note 45.

<sup>52</sup> Registrants using a Form B registration statement could communicate freely both prior to and after filing the registration statement. Aircraft Carrier, *supra* note 5, at 67,210-12; 67,214-16. An issuer would be eligible to use Form B if either (1) its "public float" (the aggregate market value of its common equity securities held by non-affiliates) is \$75 million or more and the average daily trading volume of its equity securities is \$1 million or more; or (2) its public float is \$250 million or more. Aircraft Carrier, *supra* note 5, at 67,185.

<sup>53</sup> Aircraft Carrier, *supra* note 5, at 67,212-16.

<sup>54</sup> See, e.g., Securities Act Release No. 3844, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 3250-56 (Oct. 8, 1957).

## II. AN INTRODUCTION TO THE TRANSACTION EXEMPTIONS

The registration requirement in the Securities Act is not absolute; there are exemptions, and most of the exemptions are also transactional.<sup>55</sup> The most important transaction exemptions available to issuers can be classified into three categories based on the economic justification for the exemption: (1) *small offering exemptions*, for offerings of a limited dollar amount; (2) *sophisticated offeree exemptions*, for offerings to purchasers able to fend for themselves without the protection of registration; and (3) *deference exemptions*, for offerings regulated by some entity other than the SEC.<sup>56</sup> One of the Securities Act exemptions, the intrastate offering exemption, is difficult to categorize along these lines, so it is discussed separately.

### A. Small Offering Exemptions

The small offering exemptions limit the total dollar amount of securities sold in the offering. The principal small offering exemptions are Regulation A<sup>57</sup> and Rules 504<sup>58</sup> and 505<sup>59</sup> of Regulation D. The economic rationale for the small offering exemptions is based on economies of scale in registration.<sup>60</sup> Because of relatively large fixed costs, the cost to register a small offering exceeds the benefits associated with registration. Only when the size of the

---

<sup>55</sup> Not all of the exemptions in the Securities Act are transactional. Some securities are permanently exempt from registration under the exemptions. See 15 U.S.C. § 77c(a)(2)-(8) (1994 & Supp. 1995). Because of the nature of the issuer or the character of the security, these securities are permanently exempted from registration no matter how they are distributed or sold. In other words, the type of transaction does not alter their status as exempt securities. See 7 J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, at 1-19 (1999 rev.); see also JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 547 (1991) (summarizing various rationales for securities exemptions).

<sup>56</sup> For a more complete discussion of the economic rationales for the three types of exemptions discussed in the text, see Bradford, *supra* note 12, at 609-35. This Article focuses on the major exemptions available to issuers raising new capital. Exemptions available for employee benefit plans are beyond the scope of this Article. See 17 C.F.R. § 230.701 (1999); see also Robert B. Robbins, *Securities Offerings to Employees, Consultants, and Advisers Under Rule 701*, 31 REV. SEC. & COMM. REG. 51 (1998). The bankruptcy exemptions, some of which appear in the Bankruptcy Code rather than in the Securities Act, are also beyond the scope of this Article. See 11 U.S.C. §§ 364(f), 1145(a) (1994); 15 U.S.C. § 77c(a)(7) (1994); see also 3 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1229-30, 1287-93 (3d ed. 1999); Richard J. Morgan, *Application of the Securities Laws in Chapter 11 Reorganizations Under the Bankruptcy Reform Act of 1978*, 1983 U. ILL. L. REV. 861.

<sup>57</sup> 17 C.F.R. §§ 230.251 to 230.263 (1999).

<sup>58</sup> *Id.* § 230.504.

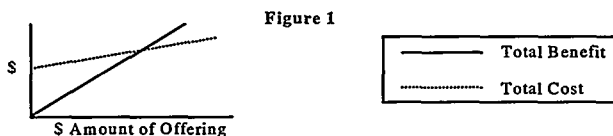
<sup>59</sup> *Id.* § 230.505.

<sup>60</sup> For a more complete discussion of this theory, see Bradford, *supra* note 12, at 614-18.

offering is larger does the benefit of registration justify its cost.<sup>61</sup> Of course, the fact that full registration of smaller offerings is not economically justified does not mean that investor protection is unjustified. Intermediate disclosure rules that do not provide the full benefit of registration, but also have lower compliance costs, could be economically efficient for all but the smallest offerings. An incremental system in which the level of investor protection increases as the size of the offering increases<sup>62</sup> could make sense. To some extent, this describes our current system.

Rule 504 of Regulation D,<sup>63</sup> which exempts offerings with an aggregate offering price of \$1 million or less,<sup>64</sup> is the least burdensome small offering exemption. Until 1999, Rule 504 offered a virtually unrestricted federal exemption: general solicitation and advertising were allowed, no information had to be provided to investors, the number of offerees and purchasers was unlimited, and Rule 504 securities were freely resalable.<sup>65</sup> In 1999, the SEC amended Rule 504: except for state-registered offerings and certain state-exempted offerings to accredited investors,<sup>66</sup> general solicitation and advertising are now prohibited and resales are restricted.<sup>67</sup> In spite of these additional restrictions, Rule 504 remains the least restrictive small offering exemption.

<sup>61</sup> See Bradford, *supra* note 12, at 614-18. Registration involves a relatively large fixed cost, whereas the gains from registration are roughly proportionate to the size of the offering. As a result, the total cost and total benefit of registration look something like the curves in Figure 1. The total benefit of registration exceeds the total cost (in other words, registration produces a net benefit) only when the offering exceeds some minimal amount; offerings of less than that amount should be exempted.



<sup>62</sup> Or, to put it another way, the level of exemption decreases as the size of the offering increases.

<sup>63</sup> 17 C.F.R. § 230.504 (1999).

<sup>64</sup> *Id.* § 230.504(b)(2). Prior to 1992, Rule 504 provided for a \$1 million limit, but no more than \$500,000 of the securities sold could be sold without state registration. See 17 C.F.R. § 230.504(b)(2)(i) (1990) (superseded). The 1992 amendments provided for a single \$1 million exemption, regardless of whether the offering was registered in a state. See Small Business Initiatives, Securities Act Release No. 6949, 57 Fed. Reg. 36,442 (1992).

<sup>65</sup> See 17 C.F.R. § 230.504 (1998) (superseded).

<sup>66</sup> 17 C.F.R. § 230.504(b)(1)(i)-(iii) (1999).

<sup>67</sup> *Id.* §§ 230.504(b)(1), 230.502(c)-(d).

Rule 505<sup>68</sup> is the second least burdensome small offering exemption. It has a \$5 million offering amount limit,<sup>69</sup> but the issuer may sell to no more than thirty-five non-accredited purchasers, plus an unlimited number of accredited investors.<sup>70</sup> General solicitation of investors and general advertising are prohibited,<sup>71</sup> and resales are restricted.<sup>72</sup> The issuer must furnish to non-accredited investors information about the issuer, its business, and the securities being offered.<sup>73</sup> Finally, the issuer must provide purchasers with an opportunity to ask questions and obtain any additional information "which the issuer possesses or can acquire without unreasonable effort or expense" to verify the accuracy of the information required to be furnished.<sup>74</sup>

Regulation A<sup>75</sup> is the most burdensome small offering exemption. Regulation A exempts offerings with an aggregate offering price of \$5 million or less,<sup>76</sup> but it requires issuers to comply with what has been called a "mini-registration,"<sup>77</sup> a "less expensive and time consuming" version of the statutory filing and prospectus delivery requirements.<sup>78</sup> The issuer must file with the SEC a disclosure document known as an offering statement<sup>79</sup> and must provide investors with a prospectus-like document known as an offering circular.<sup>80</sup>

---

<sup>68</sup> *Id.* § 230.505.

<sup>69</sup> *See id.* § 230.505(b)(2)(i).

<sup>70</sup> *See id.* §§ 230.505(b)(2)(ii), 230.501(e)(1)(iv).

<sup>71</sup> *See id.* § 230.502(c).

<sup>72</sup> *See id.* § 230.502(d).

<sup>73</sup> *See id.* § 230.502(b)(1). The amount of information required depends on the size of the offering and whether the issuer is a reporting company under the Exchange Act. *See id.* § 230.502(b)(2). At least some audited financial statements are required in all cases. *See id.* § 230.502(b)(2). Regulation D does not require that any information be provided to accredited investors. *Id.* § 230.502(b)(1). The issuer must also inform non-accredited investors about any additional information that was provided to any accredited investors, and give them access to that information upon request. *See id.* § 230.502(b)(2)(iv).

<sup>74</sup> *Id.* § 230.502(b)(2)(v).

<sup>75</sup> *Id.* §§ 230.251-230.263.

<sup>76</sup> *Id.* § 230.251(b). The limit is \$5 million per 12-month period. The SEC's Task Force on Disclosure Simplification has proposed to change the dollar amount in Regulation A from \$5 million per 12-month period to \$5 million per 6-month period, effectively doubling the Regulation A limit. *Task Force Report, supra* note 11, at 65-66. Alternatively, the Task Force proposed to make the limit \$5 million *per offering* to allow multiple \$5 million offerings in a single 12-month period. *Id.* at 66. *See infra* notes 201-02 and accompanying text.

<sup>77</sup> 7A HICKS, *supra* note 55, at 6-19.

<sup>78</sup> *Id.* at 6-7.

<sup>79</sup> *See* 17 C.F.R. § 230.252 (1999). This offering statement is filed on Form 1-A. *See* Form 1-A, 2 Fed. Sec. L. Rep. (CCH) ¶¶ 7325-7325C (1993). Regulation A contains a "test-the-waters" provision allowing issuers to solicit potential investors prior to filing the offering statement, *see* 17 C.F.R. § 230.254 (1999), but offers to sell prior to filing Form 1-A are otherwise prohibited, *see id.* § 230.251(d)(1)(i).

<sup>80</sup> *See id.* § 230.251(d)(2)(i)(B), (C).

The offering circular includes the same narrative and financial information as the filed offering statement.

### B. *Sophisticated Offeree Exemptions*

The sophisticated offeree exemptions limit the types of buyers to whom the issuer may sell, and in some cases even offer, its securities. The economic rationale for the sophisticated offeree exemptions is that certain offerees, because of sophistication, bargaining power, or access to information about the issuer, do not sufficiently benefit from the additional protection registration provides.<sup>81</sup> The main sophisticated offeree exemptions are section 4(2) of the Securities Act<sup>82</sup> and its safe harbor, Rule 506 of Regulation D,<sup>83</sup> and the SEC's newest transaction exemption, Regulation CE.<sup>84</sup>

Section 4(2) of the Securities Act exempts "transactions by an issuer not involving any public offering."<sup>85</sup> The dollar amount of a section 4(2) private offering is unlimited.<sup>86</sup> Although the legislative history of section 4(2) provides little guidance,<sup>87</sup> the Supreme Court has held that section 4(2) was meant to exempt offerings to "those who are shown to be able to fend for themselves" or those such as "executive personnel who because of their

---

<sup>81</sup> For a more detailed discussion, see Bradford, *supra* note 12, at 624-27. For an argument that at least some of the categories of investors who may purchase in these sophisticated offeree exemptions *do* need additional protection, see Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994).

<sup>82</sup> 15 U.S.C. § 77(d)(2) (1994).

<sup>83</sup> Section 4(6) of the Securities Act, *id.* § 77(d)(6), also exempts offerings to accredited investors, but Rule 506 is available in almost every case in which section 4(6) would be available and Rule 506 is generally less restrictive, so section 4(6) "is of little, if any, use today." COX, *supra* note 55, at 433; see also 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 3A SECURITIES AND FEDERAL CORPORATE LAW § 3:23, at 3-44 (1997) (stating that the Section 4(6) exemption is "largely redundant").

Section 3(a)(9) of the Securities Act also might be classified as a sophisticated offeree exemption. It exempts "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." 15 U.S.C. § 77c(a)(9) (1994). The rationale for section 3(a)(9) is in part based on the notion that the issuer's existing security holders already have some knowledge about the company. They may have already received information about the transaction if shareholder approval for the issuance was required. In any event, the security holders are not investing additional money, but merely changing the form of their investment in an issuer about which they are presumably already informed. See 7 HICKS, *supra* note 55, at 2-126 to 2-133.

<sup>84</sup> 17 C.F.R. § 230.1001 (1999).

<sup>85</sup> 15 U.S.C. § 77d(2) (1994).

<sup>86</sup> See *id.*

<sup>87</sup> See 3 LOSS & SELIGMAN, *supra* note 56, at 1362-63.



position have access to the same kind of information that the Act would make available in the form of a registration statement."<sup>88</sup>

Rule 506 of Regulation D is a regulatory safe harbor for section 4(2).<sup>89</sup> It exempts sales of an unlimited dollar amount of securities to two classes of investors: (1) up to thirty-five purchasers each of whom "either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment;"<sup>90</sup> and (2) an unlimited number of "accredited investors."<sup>91</sup> The term "accredited investor" is defined to include institutional investors, wealthy individuals, and directors, executive officers, and partners of the issuer.<sup>92</sup> Rule 506 has the same information requirements as Rule 505<sup>93</sup> and similarly restricts solicitation<sup>94</sup> and resales.<sup>95</sup>

The most recent sophisticated offeree exemption is Regulation CE.<sup>96</sup> Regulation CE exempts from federal registration offers and sales that satisfy section 25102(n) of the California Corporations Code, as long as the aggregate offering price does not exceed \$5 million.<sup>97</sup> The California exemption is similar to Rule 506, limiting sales to "qualified purchasers"<sup>98</sup> and providing for Regulation D disclosure to some purchasers.<sup>99</sup> However, unlike Rule 506, the California exemption allows limited solicitation of investors. In essence, Regulation CE relaxes the general solicitation restriction applicable to Rule 506 offerings.

### C. Deference Exemptions

Deference exemptions exempt offerings from registration when some other agency or a court is already reviewing the offering. The economic rationale

---

<sup>88</sup> SEC v. Ralston Purina Co., 346 U.S. 119, 125-26 (1953).

<sup>89</sup> Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251, 11,252 (1982).

<sup>90</sup> 17 C.F.R. § 230.506(b)(2)(i), (ii) (1999).

<sup>91</sup> *Id.* §§ 230.506(b)(2)(i), 230.501(e)(1)(iv).

<sup>92</sup> *Id.* § 230.501(a).

<sup>93</sup> *Id.* § 230.502(b)(2). See *supra* text accompanying notes 73-74.

<sup>94</sup> 17 C.F.R. § 230.502(c) (1999).

<sup>95</sup> *Id.* § 230.502(d).

<sup>96</sup> *Id.* § 230.1001. See C. Steven Bradford, *The SEC's New Regulation CE Exemption: Federal-State Coordination Run Rampant*, 52 U. MIAMI L. REV. 429 (1998).

<sup>97</sup> 17 C.F.R. § 230.1001(b) (1999).

<sup>98</sup> CAL. CORP. CODE § 25102(n)(2) (West Supp. 2000). For a comprehensive listing of the categories of investors qualifying as "qualified purchasers," see Bradford, *supra* note 96, at 454-59.

<sup>99</sup> CAL. CORP. CODE § 25102(n)(4).

for the deference exemptions is based on comparative regulatory advantage: Some regulator other than the SEC is already regulating the offering and, given that alternative regulation, registration with the SEC would not produce a positive net benefit.<sup>100</sup>

The primary deference exemption available outside of the bankruptcy context is section 3(a)(10) of the Securities Act.<sup>101</sup> Section 3(a)(10) exempts any security<sup>102</sup> issued at least partly in exchange for other securities, claims or property interests, where any court, federal agency, or state banking or insurance commission approves the exchange after a hearing on its fairness.<sup>103</sup> The basis of this exemption is a belief that "the examination and approval by the body in question of the fairness of the issue in question is a substitute for the protection afforded to the investor by the information which would otherwise be made available to him through registration."<sup>104</sup>

#### D. The Intrastate Offering Exemption

One other important exemption is difficult to categorize, primarily because its economic justification is relatively weak. Section 3(a)(11) of the Securities Act<sup>105</sup> exempts purely intrastate offerings: "Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."<sup>106</sup> Section 3(a)(11) imposes several requirements: (1) all of the offerees must reside in the state; (2) the issuer must reside in the state, or if it is a corporation, be incorporated in the state; (3) the issuer must have substantial operations in the state; and (4) substantially all of the proceeds of the offering must be used within the state.<sup>107</sup> Rule 147<sup>108</sup> is a regulatory

---

<sup>100</sup> For a more complete discussion of this theory, see Bradford, *supra* note 12, at 630-35.

<sup>101</sup> 15 U.S.C. § 77c(a)(10) (1994). In the bankruptcy context, section 1145(a) of the Bankruptcy Code, 11 U.S.C. § 1145(a) (1994), conditioned on the review and approval of the sale by the bankruptcy court that occurs during confirmation of a plan, clearly is a deference exemption. Section 364(f) of the Bankruptcy Code, 11 U.S.C. § 364(f) (1994), closely related to the security exemption in section 3(a)(7) of the Securities Act, 15 U.S.C. § 77c(a)(7) (1994), is also, at least in part, a deference exemption. See Bradford, *supra* note 12, at 629-30 and authorities cited therein.

<sup>102</sup> There is an exception for securities exchanged in a case under title 11 of the United States Code. 15 U.S.C. § 77c(a)(10) (1994).

<sup>103</sup> *Id.* § 77c(a)(10).

<sup>104</sup> Securities Act Release No. 312, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2171-2184, at 2591 (Mar. 15, 1935).

<sup>105</sup> 15 U.S.C. § 77c(a)(11) (1994).

<sup>106</sup> *Id.* § 77c(a)(11).

<sup>107</sup> See Securities Act Release No. 5450, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,617

safe harbor for section 3(a)(11); it attempts to clarify the requirements for exemption.<sup>109</sup>

The legislative history of section 3(a)(11) is "sparse,"<sup>110</sup> but two possible rationales have been offered by the SEC.<sup>111</sup> One rationale, which places the exemption in the sophisticated offeree category, is that an intrastate offering will involve local offerees familiar with the issuer who, because of their proximity to and familiarity with the issuer, do not need the protection of federal registration.<sup>112</sup> This rationale is suspect: an investor in New York, for example, cannot possibly be familiar with all New York companies.<sup>113</sup> A second rationale for section 3(a)(11) is that, because of the local nature of the offering, state regulation is adequate and federal regulation is not needed.<sup>114</sup> This rationale seems more plausible, although it is also subject to objections.<sup>115</sup> Under this rationale, section 3(a)(11) is a deference exemption. In the rest of this Article, I shall treat section 3(a)(11) and Rule 147 as deference exemptions, although nothing proposed turns on that classification.

at 83,650-654 (Jan. 7, 1974), and cases cited therein. Rule 147 provides more specific guidance as to each of these requirements. See 17 C.F.R. § 230.147 (1999).

<sup>108</sup> 17 C.F.R. § 230.147 (1999).

<sup>109</sup> See Preliminary Notes accompanying *id.* § 230.147.

<sup>110</sup> 3 LOSS & SELIGMAN, *supra* note 56, at 1295.

<sup>111</sup> See, e.g., Securities Act Release No. 5450, *supra* note 107, at 2611-12 ("In theory, the investors would be protected both by their proximity to the issuer and by state regulation").

<sup>112</sup> For example, the Task Force on Disclosure Simplification, suggesting that the exemption be available to offerees employed but not residing in the state of the offering, noted that "an individual investor may be equally (or even more) familiar with companies located around his or her place of employment as those located near his or her residence." *Task Force Report*, *supra* note 11, at 62. Similarly, the 1963 Special Study of Securities Markets noted that the section 3(a)(11) exemption "is typically available for the offering by a small businessman of a limited amount of securities to his friends, relatives, business associates, and others." SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 571 (1963).

<sup>113</sup> See 7 HICKS, *supra* note 55, at 4-167 to 4-168 (rejecting the idea that investors' proximity to and knowledge of the issuer justifies the intrastate offering exemption).

<sup>114</sup> Under this view, section 3(a)(11) was designed to exempt "those securities which were being supervised effectively by State regulation." *Chapman v. Dunn*, 414 F.2d 153, 157 (6th Cir. 1969). As the 1963 Special Study of Securities Markets stated,

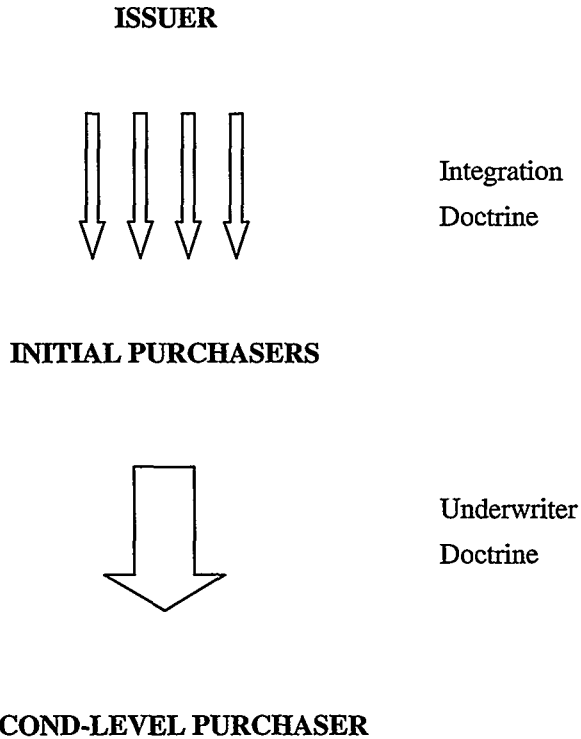
The exemption reflects a congressional policy . . . not to preempt the field of securities regulation or to supersede State control, but rather to fill the gap in those areas where State regulation cannot adequately meet a national need. . . . Small local offerings of this character . . . can be adequately supervised by State authority to the extent that regulation is deemed necessary.

REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, *supra* note 112, at 570-71.

<sup>115</sup> See 7 HICKS, *supra* note 55, at 4-168 to 4-169.

### III. THE TRANSACTIONAL BASIS OF EXEMPTIONS FROM THE REGISTRATION REQUIREMENT

The exemptions from the registration requirement are transactional. An issuer's entire offering must qualify for a single exemption, or registration is required. Exemptions are not available for parts of an offering. This transactional restriction has both horizontal and vertical elements. Consider the following diagram:



The horizontal element of the transactional exemption structure, the integration doctrine, focuses on sales of securities *directly by the issuer*. The integration doctrine asks which of all the issuer's initial sales of securities should be considered part of the same transactional offering. All of the sales that are part of a single offering must comply with the requirements of a single transaction exemption, or the exemption is lost. The horizontal element of the transaction exemptions is the focus of this Article.

The vertical element of the transaction exemptions—the underwriter concept and the associated resale restrictions<sup>116</sup>—focuses on resales of securities by those who purchase initially from the issuer.<sup>117</sup> It considers the initial purchasers' resales to what the diagram labels second-level purchasers, and asks whether the sales to the second-level purchasers also should be considered part of the issuer's transaction—in other words, whether the sales should be treated as if the issuer sold directly to the second-level purchasers. If so, then the resale, as part of the issuer's transaction, must also comply with the terms of the issuer's transaction exemption, or the issuer's exemption is lost.<sup>118</sup>

I will first discuss the underwriter doctrine and the resale restrictions, and then turn to the horizontal restrictions on exempt offerings.

### A. Resale Restrictions

#### 1. Introduction to the Underwriter Concept and Limits on Resales

The vertical element of the transaction-based exemptions rests on the "underwriter" concept, by virtue of which the Securities Act limits resales by those purchasing securities in an exempt offering.<sup>119</sup> The resale restrictions prevent an issuer from circumventing the limits of an exemption by selling through a conduit who immediately resells the security in a way the issuer's exemption would not have allowed. The issuer's transaction is not completed until the securities "come to rest."<sup>120</sup> Resales prior to that time may be attributed to the issuer and thereby destroy the issuer's exemption.<sup>121</sup>

---

<sup>116</sup> For a more detailed discussion of the resale restrictions, see Rutheford B. Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*, 52 WASH. & LEE L. REV. 1333 (1995); see also J. William Hicks, *The Concept of Transaction as a Restraint on Resale Limitations*, 49 OHIO ST. L.J. 417 (1988).

<sup>117</sup> Or, in the case of multiple resales of the same security, the vertical element of the exemption includes resales by those who purchase from the issuer's purchasers. See Hicks, *supra* note 116, at 435-36.

<sup>118</sup> *Id.* at 432-34.

<sup>119</sup> The underwriter concept at times applies to sales of unrestricted securities by controlling persons of the issuer. Under section 2(a)(11) of the Securities Act, the term "underwriter" includes any person offering or selling for an issuer in connection with a distribution. 15 U.S.C. § 77b(a)(11) (1994). For purposes of section 2(a)(11), the term "issuer" includes affiliates—"any person directly or indirectly controlling or controlled by the issuer or any person under direct or indirect common control with the issuer." *Id.* Thus, if the affiliate's resales constitute a distribution, any person selling for the affiliate would be an underwriter, destroying the section 4(1) exemption. See *id.* § 77d(1) (1994). However, the rationale for restricting affiliate resales does not turn on the transaction concept and is thus beyond the scope of this Article. See generally THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 254 (3d ed. 1996).

<sup>120</sup> See Hicks, *supra* note 116, at 432-34, 442-47.

<sup>121</sup> *Id.* at 432-34.

Section 5 of the Securities Act, containing the prohibitions that enforce the Act's registration and prospectus delivery requirements, applies to "any person," making no distinction between the initial sale of securities by an issuer and subsequent resales of those securities.<sup>122</sup> However, section 4(1) of the Securities Act exempts from the requirements of section 5 "transactions by any person other than an issuer, underwriter, or dealer."<sup>123</sup> An ordinary resale is not usually made by the issuer of the security,<sup>124</sup> nor is the usual reseller a dealer, defined as someone "in the business of offering, buying, selling or otherwise dealing or trading in securities issued by another person."<sup>125</sup> It is the underwriter portion of the section 4(1) exemption that enforces the transactional prohibition on resales.

The important part of the definition of an underwriter for this purpose is "any person who has purchased from an issuer with a view to . . . the distribution of any security."<sup>126</sup> This definition raises two key issues. First, when the person purchased the security from the issuer, was his intent to resell or was his intent to hold the security for investment purposes? To put it another way, did he have investment intent when he purchased? Second, even if he purchased with a view to reselling, are his resales a "distribution"?

Investment intent is difficult to prove, as it involves an inquiry into the purchaser's state of mind. Investment intent is usually established by holding the securities a sufficiently long period of time prior to resale. This holding period demonstrates that the seller did not originally purchase the securities intending to resell them.<sup>127</sup> The exact amount of time necessary was unclear until Rule 144 was adopted, but a two-year rule of thumb was often used.<sup>128</sup> Even in the absence of an extended holding period, prior to the adoption of Rule 144 a seller could prove investment intent by showing that he intended to hold the securities, but a change of circumstances precipitated an earlier sale.<sup>129</sup>

---

<sup>122</sup> 15 U.S.C. § 77e (1994).

<sup>123</sup> *Id.* § 77d(1).

<sup>124</sup> The term "issuer" is defined, somewhat circuitously, as "every person who issues or proposes to issue any security," with some exceptions. *Id.* § 77b(4).

<sup>125</sup> *Id.* § 77b(a)(12). Even if the person reselling happens to be a dealer, the Securities Act contains a separate exemption for transactions by dealers who are not otherwise underwriters. *Id.* § 77d(3).

<sup>126</sup> *Id.* § 77b(a)(11).

<sup>127</sup> See HAZEN, *supra* note 119, at 261; Campbell, *supra* note 116, at 1344; 7B HICKS, *supra* note 55, at § 9.02[2][a][ii][A].

<sup>128</sup> See HAZEN, *supra* note 119, at 261.

<sup>129</sup> See *id.* at 260; Campbell, *supra* note 116, at 1344; 7B HICKS, *supra* note 55, at § 9.02[2][a][ii][B]. When the SEC adopted Rule 144 in 1972, it indicated that it was eliminating the "change of circumstances"

A seller who cannot establish investment intent may nevertheless avoid underwriter status by showing that his resales are not a "distribution."<sup>130</sup> Although practice is somewhat divorced from theory,<sup>131</sup> for non-affiliate resales, the goal is to ensure that the purchaser's resales are consistent with the issuer's original transactional exemption—that the resale is not being used to circumvent the limits on the issuer's original distribution.<sup>132</sup> Thus, for an exempt intrastate offering, immediate resales to nonresidents would be problematic, but resales within the state would not, because the issuer could have made such sales directly.<sup>133</sup> For other exemptions with resale restrictions, "distribution" is generally defined consistently with the *Ralston Purina*<sup>134</sup> criteria used to define "private offering."<sup>135</sup>

## 2. Liberalization: Easing the Transactional Limits on Resales

The application of the section 2(a)(11) definition of underwriter to resales is difficult at best. Thomas Hazen has written that "[t]he one clear lesson of the cases and SEC decisions is that section [2(a)(11)]'s definition of underwriter is a trap for the careless and unwary."<sup>136</sup> To ease that uncertainty, the SEC has adopted two important safe harbor rules, Rules 144 and 144A.<sup>137</sup>

As currently written, Rule 144 allows the resale of restricted securities after a minimum holding period of one year,<sup>138</sup> provided that the other conditions of the rule are met: certain information about the issuer must be publicly available,<sup>139</sup> only a limited number of securities may be sold,<sup>140</sup> the securities

---

concept. See Securities Act Release No. 5223, *supra* note 5, at 592. The SEC's authority to eliminate the doctrine, which is based on the language in section 2(a)(11), has been questioned. See 3 LOSS & SELIGMAN, *supra* note 56, at 1514.

<sup>130</sup> See Campbell, *supra* note 116, at 1345.

<sup>131</sup> See Hicks, *supra* note 116, at 442-59.

<sup>132</sup> See *id.* at 431-35.

<sup>133</sup> See *id.* at 433-34.

<sup>134</sup> SEC. v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (holding that whether an offering is "private" or "public" turns on "whether the particular class of persons affected need the protections of the [Securities] Act").

<sup>135</sup> Hicks, *supra* note 116, at 449-54.

<sup>136</sup> HAZEN, *supra* note 119, at 282.

<sup>137</sup> 17 C.F.R. §§ 230.144-.144A (1999). In addition, Rule 147, the intrastate offering exemption safe harbor, has its own nine-month resale restriction. 17 C.F.R. § 230.147(e) (1999).

<sup>138</sup> *Id.* § 230.144(d)(1).

<sup>139</sup> *Id.* § 230.144(c).

<sup>140</sup> *Id.* § 230.144(e)(1).

must be sold in "brokers' transactions,"<sup>141</sup> and, in some cases, a notice of sale must be filed with the SEC.<sup>142</sup> After a holding period of two years, a non-affiliate of the issuer may freely resell without complying with these additional conditions.<sup>143</sup>

Rule 144 has been substantially liberalized over the years. When it was originally adopted in 1972, the minimum holding period was two years and the conditions on resale applied no matter how long the securities were held.<sup>144</sup> In 1981, the SEC added section 144(k), eliminating all the additional conditions except the public information requirement for non-affiliates who had held the securities for three years.<sup>145</sup> In 1983, the SEC also eliminated the public information requirement for Rule 144(k) sales.<sup>146</sup> The most recent changes came in 1997, when the SEC reduced the generally applicable Rule 144 holding period from two years to one year and reduced the 144(k) holding period from three years to two years.<sup>147</sup> At the same time, the SEC solicited comments on whether the holding periods should be shortened even more, to six months or even three months.<sup>148</sup>

Thus, Rule 144's history has been one of gradual liberalization, with the most dramatic changes coming in the last few years. As the SEC reduces the Rule 144 holding period and eliminates the other restrictions on Rule 144 resales of restricted securities, it is, in essence, minimizing the transactional connection between resales and the issuer's original transaction. The question of whether the issuer's sales and the resales are part of the same transaction persists, but it is much easier to conclude that they are not.

Rule 144A,<sup>149</sup> adopted by the SEC in 1990,<sup>150</sup> goes even further. Rule 144A rejects the transactional view entirely, completely divorcing resales from

---

<sup>141</sup> *Id.* § 230.144(f). Rule 144 provides a non-exclusive definition of "brokers' transaction." *See id.* § 230.144(g).

<sup>142</sup> *Id.* § 230.144(h).

<sup>143</sup> *Id.* § 230.144(k).

<sup>144</sup> *See* Securities Act Release No. 5223, *supra* note 5.

<sup>145</sup> *See* Resales of Securities, Securities Act Release No. 6286, 46 Fed. Reg. 12,195 (1981).

<sup>146</sup> *See* Securities; Reporting and Recordkeeping Requirements, Securities Act Release No. 6488, 48 Fed. Reg. 44,770 (1983).

<sup>147</sup> Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 7390, 62 Fed. Reg. 9242 (1997).

<sup>148</sup> Revision of Rule 144, Rule 145 and Form 144, Securities Act Release No. 7391, 62 Fed. Reg. 9246, 9250-51 (1997).

<sup>149</sup> 17 C.F.R. § 230.144A (1999).

<sup>150</sup> Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6862, 55 Fed. Reg. 17,933 (1990).



the exemption for the issuer's original sales. Rule 144A, like Rule 144, protects a person who resells securities from being treated as an underwriter.<sup>151</sup> Rule 144A allows a purchaser to resell securities to certain institutional investors, known as qualified institutional buyers.<sup>152</sup> Certain other conditions must be met for Rule 144A to be available,<sup>153</sup> but the availability of Rule 144A does not depend on how much time has expired since the securities were issued or on whether the seller had investment intent when he purchased the securities. The resales are completely divorced from the issuer's original offering, no matter how soon they occur or how inconsistent they are with the issuer's exemption. Rule 144A resales "shall be deemed not to affect the availability of any exemption or safe harbor relating to any previous or subsequent offer or sale of such securities by the issuer."<sup>154</sup>

## B. *The Integration Doctrine*

### 1. *An Introduction to the Integration Doctrine*

The second transactional element of the exemptions from registration is horizontal. To avoid registration, the offering as a whole must meet the requirements of a single exemption. An issuer may not use two or more exemptions to cover parts of what is really a single transaction.<sup>155</sup> The SEC uses the integration doctrine to determine what constitutes a single offering. If two sets of sales are really part of the same transaction, the sales are "integrated" and treated as a single offering, and the entire integrated offering must qualify for a single exemption. The integration doctrine thus prevents an issuer from separating a single offering into two parts and using a separate exemption for each part (or registering one part and using an exemption for the other part).<sup>156</sup>

The integration doctrine originated in 1933, shortly after the passage of the Securities Act. Section 3(a)(11) exempts securities that are "part of an issue

---

<sup>151</sup> 17 C.F.R. § 230.144A(b) (1999).

<sup>152</sup> *Id.* § 230.144A(d)(1). "Qualified institutional buyer" is defined at *id.* § 230.144A(a)(1).

<sup>153</sup> *Id.* § 230.144A(d)(2)-(4). For a thorough review of these conditions and the rest of Rule 144A, see 7B HICKS, *supra* note 55, ch. 10A.

<sup>154</sup> 17 C.F.R. § 230.144A(e) (1999); see also C. Steven Bradford, *Rule 144A and Integration*, 20 SEC. REG. L.J. 37 (1992).

<sup>155</sup> See Hicks, *supra* note 116, at 431.

<sup>156</sup> For a review of various contexts in which the integration doctrine can arise, see Stephen I. Glover, *The Offerings That Precede an Initial Public Offering—How to Preserve Exemptions and Avoid Integration*, 24 SEC. REG. L.J. 3 (1996).

offered and sold only to persons resident within a single State or Territory.”<sup>157</sup> The Federal Trade Commission, which at the time enforced the Securities Act, ruled that an issuer could not sell part of an issue using the intrastate offering exemption and then sell the rest of the issue in an interstate registered public offering.<sup>158</sup> Shortly after that ruling, the SEC held that even a single sale to a non-resident could destroy the section 3(a)(11) exemption.<sup>159</sup> The SEC subsequently indicated that the word “exclusively” in section 3(a)(9) and the phrase “not involving any public offering” in section 4(2) similarly require that the entire offering fall within one exemption.<sup>160</sup>

Most of the major transaction exemptions adopted by the SEC now include either language specifically incorporating the “offering” or “issue” concepts or notes specifically warning of the possibility of integration. Rule 147, for example, provides that “all securities of the issuer which are *part of an issue* shall be offered, offered for sale or sold in accordance with all of the terms and conditions of this rule.”<sup>161</sup> Regulation D similarly provides that “[a]ll sales that are *part of the same Regulation D offering* must meet all of the terms and conditions of Regulation D.”<sup>162</sup> The text of Regulation A does not expressly adopt the offering or issue concept, but the SEC extended the concept to Regulation A in 1948,<sup>163</sup> and a note accompanying Regulation A makes it clear that the integration doctrine will be applied to offers or sales not protected by Regulation A’s integration safe harbor.<sup>164</sup> Regulation CE,<sup>165</sup> the most recent transaction exemption, does not expressly provide for integration, but it mirrors a California state exemption which is itself transactional.<sup>166</sup>

<sup>157</sup> 15 U.S.C. § 77c(a)(11) (1994).

<sup>158</sup> See Securities Act Release No. 97, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 1021-1029, at 2056 (Dec. 28, 1933).

<sup>159</sup> See *Petersen Engine Co.*, 2 S.E.C. 893, 899 (1937).

<sup>160</sup> See Securities Act Release No. 2029, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2140-2141, at 2584 (Aug. 8, 1939).

<sup>161</sup> 17 C.F.R. § 230.147(b)(1) (1999) (emphasis added); see also *id.* § 230.147, Preliminary Note 3.

<sup>162</sup> *Id.* § 230.502(a) (emphasis added) and accompanying note.

<sup>163</sup> See Herbert R. May, 27 S.E.C. 814, 818-20 (1948).

<sup>164</sup> 17 C.F.R. § 230.251(c) (1999) and accompanying note.

<sup>165</sup> *Id.* § 230.1001.

<sup>166</sup> Regulation CE exempts offers or sales of securities that fall within § 25102(n) of the California Corporations Code. *Id.* § 230.1001(a). Section 25102(n), in turn, exempts “[a]ny offer or sale of any security in a transaction . . . that meets all of the following criteria.” CAL. CORP. CODE § 25102(n) (West 2000) (emphasis added). Thus, it appears that the entire transaction must meet all of the criteria of the rule. In interpreting another California exemption with similar transactional language, the California Commissioner of Corporations stated:

The “transaction” referred to is one or more offers or sales of a security which have such a connection with each other as to be considered one transaction for statutory purposes . . . . It is the statutory concept of “transaction” which determines whether or not other offer or sales of

In 1961, the SEC articulated a five-factor integration test to determine when to integrate ostensibly separate offerings.<sup>167</sup> The SEC still uses this test, which has also been followed by many courts.<sup>168</sup> The five-factor test asks whether:

- (1) the different offerings are part of a single plan of financing,
- (2) the offerings involve issuance of the same class of security,
- (3) the offerings are made at or about the same time,
- (4) the same type of consideration is to be received, [and]
- (5) the offerings are made for the same general purpose.<sup>169</sup>

All five factors do not need to be met in order for two offerings to be integrated; according to the SEC, "[a]ny one or more" of the factors may be determinative.<sup>170</sup> In practice, the SEC seems to give more weight to some of the factors than to others,<sup>171</sup> and some SEC interpretations of the integration doctrine seem to utilize factors other than the five listed.<sup>172</sup>

Closely related to the integration doctrine is the concept of aggregation,<sup>173</sup> which is used to calculate the maximum offering amount in some of the ex-

securities, past, present, or future, will be considered as constituting a part of the transaction under the exemption and integrated with it, and whether such integration will result in a violation of any of the limitations of the exemption.

Release No. 67-C, California Commissioner of Corporations, *reprinted in* 1A Blue Sky L. Rep. (CCH) ¶ 12,558, at 8054-55 (Oct. 20, 1981). However, there is some ambiguity in the text of Regulation CE itself. See Bradford, *supra* note 96, at 448-49.

<sup>167</sup> See Exemption for Local Offerings From Registration, Securities Act Release No. 4434, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2270-77, at 2608 (Dec. 6, 1961).

<sup>168</sup> See, e.g., *Donohoe v. Consolidated Operating & Prod. Corp.*, 982 F.2d 1130, 1140 (7th Cir. 1992); *SEC v. Murphy*, 626 F.2d 633, 645-46 (9th Cir. 1980). See generally 3 LOSS & SELIGMAN, *supra* note 56, at 1233 n.8 (collecting cases following the five-factor test).

<sup>169</sup> Non-Public Offering Exemption, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2770-83 (Nov. 6, 1962). *Accord*, Securities Act Release No. 4434, *supra* note 167.

<sup>170</sup> Securities Act Release No. 4434, *supra* note 167.

<sup>171</sup> See COX, *supra* note 55, at 429-31; 3 LOSS & SELIGMAN, *supra* note 56, at 1242. "In a number of no-action letters, a single criterion . . . has taken precedence over the remaining four." Committee on Federal Regulation of Securities, *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595, 623 (1986).

<sup>172</sup> See Perry E. Wallace, Jr., *Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Businesses*, 45 WASH. & LEE L. REV. 935, 940 (1988).

<sup>173</sup> See generally Bradford, *supra* note 12, at 657-58.

emptions. Regulation A, Rules 504 and 505 of Regulation D, and Regulation CE all limit the aggregate offering price of an exempted offering.<sup>174</sup> That maximum offering price must be reduced by the amount of other specified sales of securities, usually without regard to whether those other sales are part of the same offering.<sup>175</sup> For example, Rule 504's \$1 million cap is reduced by "the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this [Rule 504], in reliance on any exemption under section 3(b), or in violation of section 5(a) of the Securities Act."<sup>176</sup>

The integration doctrine has been thoroughly criticized. A number of authors have documented the problems the integration concept causes issuers in various contexts.<sup>177</sup> I do not intend to repeat those demonstrations here, but the consensus is clear: the integration doctrine "frustrate[s] issuers engaged in the capital formation process, engulfing them in a sea of ambiguity, uncertainty, and potential liability."<sup>178</sup> As Rutheford B. Campbell, Jr. concluded, "[e]veryone seems to agree that these criteria are nearly impossible to apply, principally because neither the Commission nor the courts [has] ever adequately articulated how . . . [the five factors] . . . are to be weighed or how many factors must be present in order for integration to occur."<sup>179</sup> SEC staff interpretations of the test in no-action letters have been confusing and sometimes inconsistent.<sup>180</sup> An American Bar Association subcommittee said that the no-action letters dealing with integration were "difficult to reconcile even when dealing with similar fact situations involving the same subject

---

<sup>174</sup> See 17 C.F.R. §§ 230.251(b) (Regulation A), 230.504(b)(2) (Rule 504), 230.505(b)(2)(i) (Rule 505), 230.1001(b) (Regulation CE) (1999).

<sup>175</sup> Regulation CE is an exception, wedding the aggregation and integration concepts. The Regulation CE \$5 million cap is reduced by "the aggregate offering price for all other securities sold in the same offering of securities, whether pursuant to this or another exemption." *Id.* § 230.1001(b) (1999) (emphasis added). See generally Bradford, *supra* note 96, at 448-49.

<sup>176</sup> 17 C.F.R. § 230.504(b)(2) (1999). Compare *id.* § 230.505(b)(2)(i) (similar), with *id.* § 230.251(b) (aggregating only other sales pursuant to Regulation A).

<sup>177</sup> See Glover, *supra* note 156; Judith D. Fryer, *Integration Issues in Real Estate Securities Offerings*, INSIGHTS, May 1995, at 13; Stanley Keller, *Basic Securities Act Concepts Revisited*, INSIGHTS, May 1995, at 5.

<sup>178</sup> Wallace, *supra* note 172, at 989.

<sup>179</sup> Campbell, *supra* note 14, at 164 (footnote omitted); accord Committee on Federal Regulation of Securities, *supra* note 161, at 623; Cheryl L. Wade, *The Integration of Securities Offerings: A Proposed Formula That Fosters the Policies of Securities Regulation*, 25 LOY. U. CHI. L.J. 199, 222 (1994); Wallace, *supra* note 172, at 940.

<sup>180</sup> See Subcommittee on Partnerships, Trusts and Unincorporated Assoc., *Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering*, 37 BUS. LAW. 1591, 1605; Wade, *supra* note 179, at 221; Wallace, *supra* note 172, at 958.

matter.”<sup>181</sup> The most charitable view that can be taken of the doctrine is that it has some basis in economic theory, but simply is not worth its cost.<sup>182</sup>

## 2. *Liberalization: Changes to the Integration Doctrine*

The changes to the integration doctrine over the years have not been as dramatic as the changes to the transactional nature of the registration system and the resale restrictions. The SEC has adopted several integration safe harbors, but there have been no challenges to the transaction concept as significant as the company registration proposal or Rule 144A. The SEC has been content merely to smooth out some of the integration doctrine's rougher edges.

The SEC adopted the first integration safe harbor, Rule 152,<sup>183</sup> in 1935.<sup>184</sup> Rule 152 protects section 4(2) private offerings from integration if “subsequently thereto the issuer decides to make a public offering and/or files a registration statement.”<sup>185</sup> Rule 152 received little attention until 1986, after which a series of SEC no-action letters liberalized its application.<sup>186</sup>

The SEC has added several other integration safe harbors since it adopted Rule 152. All of these additional safe harbors are tied to individual exemptions. Some of these safe harbors turn on the passage of time between offers: Rule 147 and Regulation D each provide that if two offerings are more than six months apart and there are no other offers or sales of the same security in the six-month period, the two offerings will not be integrated.<sup>187</sup> But other integration safe harbors and SEC rulings allow simultaneous or nearly simultaneous offerings pursuant to different exemptions. The SEC and its staff have consistently taken the position that offerings made solely to foreign

---

<sup>181</sup> Subcommittee on Partnerships, Trusts and Unincorporated Assoc., *supra* note 180, at 1605.

<sup>182</sup> Bradford, *supra* note 12, at 666-70.

<sup>183</sup> 17 C.F.R. § 230.152 (1999).

<sup>184</sup> See Securities Act Release No. 305 (Mar. 2, 1935), *reprinted in* Johnson & Patterson, *supra* note 15, at 582.

<sup>185</sup> 17 C.F.R. § 230.152 (1999).

<sup>186</sup> See Johnson & Patterson, *supra* note 15, at 556-61; Gerald Backman & Robert Gervis, *Integration Revisited: The Black Box Restructuring*, INSIGHTS, Feb. 1991, at 3. Significant uncertainties remain in the application of the rule. See Keller, *supra* note 177, at 9.

<sup>187</sup> See 17 C.F.R. §§ 230.147(b)(2), 230.502(a) (1999). Rule 502(a) allows “offers or sales of securities under an employee benefit plan” within the six-month period. *Id.* § 230.502(a). These integration safe harbors are “one-sided.” They protect from integration only the offering pursuant to the regulation in which the safe harbor appears. The other offering that presents the integration problem is still subject to integration and loss of its exemption, unless it has its own integration safe harbor. See C. Steven Bradford, *Regulation A and the Integration Doctrine: The New Safe Harbor*, 55 OHIO ST. L.J. 255, 270-72 (1994).

investors will not be integrated with domestic offerings, even if those offerings are simultaneous.<sup>188</sup> Regulation A, which used to have only a six-month safe harbor similar to the ones in Rule 147 and Regulation D, now baldly states that Regulation A offerings will not be integrated with *any* prior offers or sales of securities.<sup>189</sup> And, in addition to the usual six-month integration safe harbor for subsequent offers, Regulation A also excludes from integration subsequent offers or sales *within six months* that are registered, rely on Rule 701, are pursuant to an employee benefit plan, or rely on Regulation S.<sup>190</sup> Rule 701, which exempts offerings pursuant to certain compensatory benefit plans or compensation contracts, protects the Rule 701 offering from integration with “any other offering or sale whether registered under the Act or otherwise exempt from the registration requirements of the Act.”<sup>191</sup>

While the Advisory Committee was examining the registration system, an internal SEC task force was considering, among other things, the exemptions from registration. SEC Chairman Arthur Levitt organized the Task Force on Disclosure Simplification in August 1995 “to review rules and forms affecting capital formation, with a view toward streamlining, simplifying, and modernizing the overall regulatory scheme without compromising or diminishing important investor protections.”<sup>192</sup> Unfortunately, the Task Force’s report, issued in 1996, was much less revolutionary than the Advisory Committee’s company registration proposals. The Task Force proposals merely tinkered

---

<sup>188</sup> This position dates at least to 1964, when the SEC indicated in a release that section 4(2) private offerings and foreign offerings would not be integrated. Registration of Foreign Offerings by Domestic Issuers, Securities Act Release No. 4708, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 1361-63, at 2124 (July 9, 1964); *see also* College Retirement Equities Fund, SEC No-Action Letter, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,503, at 77,612 (June 4, 1987); College Retirement Equities Fund, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,420, at 77,361 (Feb. 18, 1987). Subsequent no-action letters extended this protection from integration to domestic offerings under section 3(a)(11) and Rule 147 and to domestic registered offerings. *See* Commonwealth Equity Trust, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,412, at 77,332 (Jan. 20 1987); Goldman, Sachs & Co., SEC No-Action Letter, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,164 (June 5, 1985); Scientific Mfg., Inc., SEC No-Action Letter, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,505, at 78,625 (May 12, 1983); Williams Island Assoc., Ltd., SEC No-Action Letter, 1983 WL 28343 (May 4, 1983). A note to Rule 502(a) of Regulation D extends this protection from integration to Regulation D offerings, 17 C.F.R. § 230.502(a), Note, and Rule 251(c)(2)(ii) extends this protection to Regulation A offerings, 17 C.F.R. § 230.251(c)(2)(ii) (1999).

<sup>189</sup> 17 C.F.R. § 230.251(c)(1) (1999).

<sup>190</sup> *Id.* § 230.251(c)(2)(i)-(iv).

<sup>191</sup> *Id.* § 230.701(b)(6).

<sup>192</sup> *Task Force Report*, *supra* note 11, at 1; *see also* Regulation D; Accredited Investor and Filing Requirements, Securities Act Release No. 6825, 54 Fed. Reg. 11,369 (1989) (adopting changes).

with the existing exemption system and proposed no significant changes to its transactional foundation.

The Task Force's most significant integration proposals relate to Rule 152 and the integration of exempt offerings with public offerings. The Task Force suggested that Rule 152 be liberalized to allow a company to switch from a private offering to a public offering without any delay and to allow a company "to engage in 'test the waters' offering activities among qualified investors in reliance on the private offering exemption prior to filing a registration statement."<sup>193</sup> The Task Force recommended that the SEC also consider similar protection for offerings exempted by the section 3(b) exemptions—that an exempt offering "not be integrated with either a subsequent public offering or an earlier abandoned public offering."<sup>194</sup> Further, the Task Force asked the SEC to consider whether a company should be able to begin an offering as an exempt offering and complete it as a registered offering, without integration problems.<sup>195</sup> Finally, the Task Force proposed to eliminate the "presumptive public offering" doctrine, which deems the filing of a registration statement a solicitation and precludes an immediate exempted offering if the company decides a public offering is not feasible.<sup>196</sup> The Task Force asked the SEC to "consider adopting a safe harbor that would allow a company to access the private markets while it has 'quietly' filed a registration statement."<sup>197</sup>

The Aircraft Carrier, which for the most part does not deal with the transaction exemptions or the integration doctrine, followed the Task Force's lead in proposing some fairly significant changes to Rule 152.<sup>198</sup> The Aircraft Carrier proposals would expand Rule 152 to include other private offerings in addition to section 4(2) offerings, would clarify the existing rule, and would codify some of the SEC staff's interpretations of Rule 152, which currently appear in no-action letters. Most significantly, the Aircraft Carrier proposals would add a new safe harbor for private offerings following an abandoned registered offering.<sup>199</sup>

---

<sup>193</sup> *Task Force Report*, *supra* note 11, at 41.

<sup>194</sup> *Id.* at 41-42.

<sup>195</sup> *Id.*

<sup>196</sup> *Id.* at 42.

<sup>197</sup> *Id.*

<sup>198</sup> Aircraft Carrier, *supra* note 5, at 67,234-38. For a more thorough discussion of these proposals, see Stanley Keller, *The SEC Integration Proposals*, *INSIGHTS*, Jan. 1999, at 23.

<sup>199</sup> The existing safe harbor covers situations where the public offering follows the private offering. See 17 C.F.R. § 230.152 (1999).

Two other Task Force proposals concern the transactional basis of the exemptions from registration. One would make an exemption less transactional and the other would make an exemption more transactional. The Task Force suggested that a substantial compliance provision be added to Rule 147 (or the "local offering" successor to Rule 147 proposed by the Task Force) so that the exemption would not be lost due to an inadvertent, innocent sale to a non-resident.<sup>200</sup> In other words, the innocent sale would not be integrated into the Rule 147 offering to destroy the Rule 147 exemption. But another Task Force proposal suggested a change in the opposite direction—toward a more transactional view. After proposing a change in the dollar amount of Regulation A,<sup>201</sup> the Task Force suggested an alternative—that Regulation A be amended so that, instead of \$5 million a year, the limit would be \$5 million per offering, "applying standard integration analysis to determine when multiple offerings in fact constitute a single offering."<sup>202</sup> The Task Force's goal apparently was to allow multiple \$5 million offerings in a single twelve-month period. The SEC has yet to act on the Rule 147 and Regulation A proposals.

#### IV. THE DILEMMA POSED BY THE CURRENT SYSTEM

The transactional basis of the exemptions from registration presents a dilemma. On the one hand, the all-or-nothing basis of the integration doctrine traps unwary issuers and, because it does not adequately capture the marginal effect of sales of securities on the case for registration, the doctrine forces registration in situations where offerings should be exempt. On the other hand, eliminating the integration doctrine entirely would give issuers carte blanche to split their offerings freely and avoid registration even when there is no policy basis for an exemption—when the benefits to investors of registering the entire offering would exceed the cost. Unable to find a global solution to this

---

<sup>200</sup> *Task Force Report*, *supra* note 11, at 62-63. To take advantage of the proposed substantial compliance rule, three conditions would have to be met: "a) the issuer must have reasonably believed that the non-resident was in fact a resident; b) the number of inadvertent non-resident purchasers was de minimis; and c) the issuer must have made a good faith effort to comply with all of the Rule's provisions." *Id.* at 63. The Task Force also proposed to change Rule 147's focus from offerees to purchasers, so there would be no violation of the rule if a non-resident inadvertently became an offeree. *Id.* at 63.

<sup>201</sup> The Task Force recommended that the twelve month, \$5 million limit in Regulation A be changed to \$5 million every six months. According to the Task Force, "[c]hanging the limit on the ceiling in this way would assure that small businesses have more frequent access to the marketplace and can continue to play their essential role in the success of the U.S. market system." *Id.* at 65-66.

<sup>202</sup> *Id.* at 66.



dilemma that would balance investor protection and cost minimization, the SEC retained the integration doctrine and developed narrow integration safe harbors to ease at least some of the burden on issuers. Almost everyone concedes that this solution is inadequate, but no one has been able to resolve the dilemma.

#### A. *The Problem with the Integration Doctrine*

The main failing of the integration doctrine, other than its uncertainty,<sup>203</sup> is its failure to consider the case for registration on a marginal basis. Assume, for example, that an issuer sells \$2.5 million of securities to thirty-five purchasers in a Rule 505 offering. It then sells \$10 more of the securities to a single purchaser in an offering that, considered alone, complies with Rule 504. Assume further that the \$10 sale would be integrated with the \$2.5 million offering.<sup>204</sup> Rule 504 would not be available to this integrated offering because it exceeds the \$1 million limit. Rule 505 would not be available because the integrated offering exceeds Rule 505's thirty-five-purchaser limit. Since no exemption is available for the entire, integrated offering, the offering should have been registered. The issuer is in violation of the Securities Act, and the purchasers may rescind.<sup>205</sup>

This application of the integration doctrine obviously makes no sense. The issuer could have sold an additional \$2.5 million of the security to the first thirty-five purchasers without triggering registration. The \$5 million limit, to the extent it is rational, represents a policy judgment that, even adding the additional \$2.5 million to the offering, registration would not be cost-effective. If that is true, it cannot be true that a single \$10 sale under Rule 504 makes registration of the integrated offering cost-effective. Absent implausible assumptions, the marginal change cannot justify registration.

A simple analogy illustrates the folly of the integration doctrine's failure to use marginal analysis. Assume that, to track more accurately its balance of payments, the United States enacts a law requiring citizens to report any currency taken out of the country. However, it gives a new federal agency, the

---

<sup>203</sup> See *supra* text accompanying notes 177-81.

<sup>204</sup> Even absent integration, aggregation would preclude these two offerings. The \$1 million maximum offering amount in Rule 504 is reduced by the aggregate offering price of all securities sold within the prior twelve months pursuant to any section 3(b) exemption such as Rule 505. 17 C.F.R. § 230.504(b)(2) (1999). Thus, at the time of the \$10 sale, the Rule 504 cap would be zero. The exemption would not be available. Everything said in the text about integration would also apply to the aggregation rules.

<sup>205</sup> See 15 U.S.C. § 77f (1994 & Supp. IV 1998).

Federal Currency Agency, the authority to exempt transactions from the reporting requirement if the cost to report a particular transaction exceeds the benefit. The agency decides that the cost of reporting any withdrawals of one dollar or less exceeds any benefit of the report, so it enacts four exemptions. Rule 1 says you may take up to four quarters out of the country without reporting. Rule 2 says you may take up to ten dimes out of the country without reporting. Rule 3 says you may take up to twenty nickels out of the country without reporting. Rule 4 says you may take up to one hundred pennies out of the country without reporting.

A person tries to take two quarters and three dimes out of the country and is promptly arrested for failing to file a report. The agency rejects his argument that his withdrawal was exempt from the reporting requirements. "You violate Rule 1," the agency says, "because it allows only quarters. And you violate Rule 2 because it allows only dimes. And our currency integration doctrine says all your coins must fall within a single rule. You cannot combine exemptions."

This makes no sense, of course, but neither does the application of the SEC's integration doctrine in the earlier securities example. The solution to the currency example is obvious: add all the change a person tries to take out of the country, and if the total exceeds one dollar, regardless of the combination of coins, he must file a report. In totaling the coins, we are engaging in marginal analysis: As we add each coin to the total, does that additional coin tip the scale in favor of reporting?

We need some way of totaling the amounts of securities sold pursuant to various exemptions to determine whether the total offering justifies registration—to combine the "quarters" and "dimes" of the exemptions from registration, rather than insisting that each offering consist of all "quarters" or all "dimes." And we cannot just total the combined dollar amount of the offerings any more than we can just count the total number of coins. Different exemptions offer different levels of investor protection. Adding to an offering a dollar's worth of securities sold pursuant to Regulation A bolsters the case for registration less than adding a dollar's worth of the same security sold pursuant to Rule 504 (just like adding a penny to the currency taken out of the country bolsters the case for reporting less than adding a quarter). A purchaser in a Regulation A offering gains less from registration than a purchaser in a Rule 504 offering, because the Regulation A purchaser is already receiving

substantial disclosure. We need a more sophisticated system for "counting" securities sold in different exempted transactions.

### *B. The Safe Harbors as an Incomplete Solution*

The integration safe harbors<sup>206</sup> show that the SEC recognizes and is trying to correct at least some of the problems with the integration doctrine. And the integration safe harbors do ameliorate the problems the transactional exemptions create, although they do not solve them completely.

Academics and practicing lawyers have presented a number of proposals to improve the transactional exemptions by expanding or revising the integration safe harbors. The most ambitious undertaking was the 1986 proposal of the Task Force on Integration, established by the American Bar Association's Committee on the Federal Regulation of Securities. The Task Force on Integration began with the goal of formulating "an analytical matrix, based upon objective criteria, for resolving all integration problems."<sup>207</sup> However, it gave up on that ambitious task, in part because it could not reach a consensus and in part because it did not believe the SEC would embrace such a comprehensive approach.<sup>208</sup> It instead proposed a series of broader safe harbors that turned on the distinctions between issuers,<sup>209</sup> the time between two offerings,<sup>210</sup> the type of securities being offered,<sup>211</sup> the purposes of the offerings,<sup>212</sup> and the type of exemption being used.<sup>213</sup>

---

<sup>206</sup> See *supra* text accompanying notes 183-91.

<sup>207</sup> Committee on Federal Regulation of Securities, *supra* note 171, at 597.

<sup>208</sup> *Id.*

<sup>209</sup> The Task Force simply adopted the issuer integration proposal made four years earlier by another ABA committee, the Subcommittee on Partnerships, Trusts and Unincorporated Associations. *Id.* at 631-32.

<sup>210</sup> The Task Force accepted the six-month integration safe harbor already present in some of the Securities Act rules: offerings would not be integrated if they were more than six months apart. *Id.* at 632-33.

<sup>211</sup> The Task Force classified all securities into four defined classes—common stock, preferred stock, unsecured debt, and secured debt. Offerings would not be integrated if they involved different classes. *Id.* at 633-35.

<sup>212</sup> The Task Force classified the purposes of securities offerings into four basic purposes: "(i) to raise funds for general purposes; (ii) to eliminate specific indebtedness through an exchange offering; (iii) to obtain human resources; and (iv) to acquire specific properties or businesses." *Id.* at 635. Offerings would not be integrated if they were made for different purposes. See *id.* at 635-36.

<sup>213</sup> The Task Force proposed several "policy safe harbors." *Id.* at 636-41. Section 3(a)(9) exchange offerings by reporting companies would not be integrated with other offerings. See *id.* at 637. Section 3(a)(10) offerings would also be protected from integration with other offerings, but that protection would only be one-sided. Integration would not destroy the section 3(a)(10) exemption, but the proposed safe harbor would not protect the other offering from integration. See *id.* No offering would be integrated with a registered public offering. See *id.* at 638. And domestic offerings would not be integrated with foreign

Other authors have suggested similar modifications to the integration doctrine.<sup>214</sup> Some authors have called for adoption of the ABA tests, sometimes with modifications.<sup>215</sup> A few have proposed temporal safe harbors shorter than six months.<sup>216</sup> Others have proposed modifications to the SEC's five-factor test for integration.<sup>217</sup> Some have suggested multiple approaches.<sup>218</sup>

Unfortunately, given the many ways offerings can be combined, a system of safe harbors can never be complete. The transactional integration doctrine would continue to apply to anything not covered by the safe harbors; as to those sales, the problem is the same.<sup>219</sup> The safe harbor approach is at best a

---

offerings, "so long as counsel structures the foreign offering to avoid any potential sale or resale of the offered securities to U.S. residents." *Id.* at 640-41.

<sup>214</sup> See, e.g., Darryl B. Deaktor, *Integration of Securities Offerings*, 31 U. FLA. L. REV. 465, 541-44 (1979) (calling for liberalized integration safe harbors, including a three month temporal safe harbor); Ronald L. Fein & Brian J. Jacobs, 15 REV. SEC. REG. 785, 793 (1982) (suggesting that transactions be treated as discrete unless they are part of a single plan of financing, involve the same class of security, and are contemporaneous); Kathryn Taylor Frame, *Securities Regulation: Integration of Securities Offerings*, 34 OKLA. L. REV. 864, 886 (1981) (calling for the SEC and state securities commissioners to develop a specific, objective test or definition for integration); Johnson & Patterson, *supra* note 15 (calling for a more liberal interpretation of Rule 152 and an extension of its logic to offerings under other exemptions); Fred A. Little & Robert B. Robbins, 43 WASH. & LEE L. REV. 829, 837 (1986) (approving the tests proposed by the ABA Subcommittee on Partnerships, Trusts and Unincorporated Associations); Ronald M. Shapiro & Alan R. Sachs, *Integration Under the Securities Act: Once An Exemption, Not Always . . .*, 31 MD. L. REV. 3, 26 (1971) (suggesting a twelve month temporal safe harbor, limited to no more than two offerings in a 36-month period); Wade, *supra* note 179, at 236-40 (urging a two-part inquiry: (1) adoption of the ABA Task Force's proposed safe harbors, plus a safe harbor for offerings that do not involve the same type of consideration; and (2) even outside the safe harbors, no integration if the issuer can articulate a "rational business reason" for dividing the offerings); Wallace, *supra* note 172, at 967-89 (recommending adoption of the safe harbors proposed by the ABA Committee on Federal Regulation of Securities with some modifications, including a shorter temporal safe harbor).

<sup>215</sup> See Little & Robbins, *supra* note 214, at 837 (approving the tests proposed by the ABA Subcommittee on Partnerships, Trusts and Unincorporated Associations); Daniel J. Morrissey, *Integration of Securities Offerings—The ABA's "Indiscreet" Proposal*, 26 ARIZ. L. REV. 41 (1984) (opposing the recommendations of the Subcommittee on Partnerships, Trusts and Unincorporated Associations); Wade, *supra* note 179, at 236-40 (urging a two-part inquiry, including adoption of the ABA Task Force's proposed safe harbors); Wallace, *supra* note 172, at 967-89 (recommending adoption of the safe harbors proposed by the ABA Committee on Federal Regulation of Securities with some modifications, including a shorter temporal safe harbor).

<sup>216</sup> See Deaktor, *supra* note 214, at 543 (suggesting a three-month safe harbor); Wallace, *supra* note 162, at 972-73 (suggesting a period of shorter than six months).

<sup>217</sup> See Fein & Jacobs, *supra* note 214, at 793 (suggesting that the same "type of consideration" and same "general purpose" factors be eliminated and that offerings be integrated only if all three of the other factors are present).

<sup>218</sup> See Wade, *supra* note 179, at 236-40 (urging a two-part inquiry: (1) adoption of the ABA Task Force's proposed safe harbors, plus a safe harbor for offerings that do not involve the same type of consideration; and (2) consideration of a "rational business reason" for dividing the offerings as a protection from integration).

<sup>219</sup> See Subcommittee on Partnerships, Trusts & Unincorporated Assoc., *supra* note 180, at 1607.

"patchwork . . . [with] . . . a number of sizable holes."<sup>220</sup> To return to the currency example,<sup>221</sup> a safe harbor might allow the combined exemption of two quarters and five dimes, but exclude the other possible change combinations that are equivalent to a dollar. Moreover, the very proliferation of integration safe harbors can confuse issuers. Something more than safe harbors is needed.

### C. *The Problem with Abolishing the Integration Doctrine Entirely*

A more drastic response to the problems with the integration doctrine is to eliminate it entirely: allow issuers to use the various exemptions in any combination they choose. Rutheford Campbell argued over a decade ago that the integration doctrine should be abolished, replaced by "the simple notion that any offer or sale of securities that meets either the registration requirements or the exemption requirements should not be contaminated by other offers or sales."<sup>222</sup> Others have gone almost as far. In 1979, Darryl Deaktor also briefly suggested the complete elimination of the integration doctrine, but only after the SEC made unspecified changes to the underlying exemptions so that "[f]ragmenting a single transaction into multiple offerings, each of which fully conforms to one of these rules, . . . [would not be] . . . repugnant to the interests of investors."<sup>223</sup> And Homer Kripke in 1983 called for the almost total elimination of the integration doctrine.<sup>224</sup>

Unfortunately, a completely non-transactional approach is just as problematic as the integration doctrine itself, and for the same reason: It does not consider the marginal impact of additional sales on the economic case for registration. It allows an issuer to avoid registration even where it may be cost-effective.<sup>225</sup>

---

<sup>220</sup> Glover, *supra* note 156, at 21.

<sup>221</sup> See *supra* Part IV.B.

<sup>222</sup> Campbell, *supra* note 14, at 169.

<sup>223</sup> Deaktor, *supra* note 214, at 544-46. This proposal was a relatively minor part of Professor Deaktor's article; his main argument was for an expansion of the integration safe harbors.

<sup>224</sup> Kripke proposed that "[a]ll bases for exemption may be used in tandem or successively, unless it can clearly be seen that they do in fact nullify each other." Homer Kripke, *Has the SEC Taken All the Dead Wood Out of Its Disclosure System?*, 38 BUS. LAW. 833, 843 (1983). According to Kripke, this would occur when "the group becomes so large and unwieldy and so lacking in selectivity (because of public advertising or the like) that the offering cannot be properly controlled to make sure that one or the other of the bases for exemption will apply to each purchaser." *Id.* Kripke provided no specific examples, nor did he indicate how his integration standard would be any more coherent or wieldy than the SEC's integration doctrine.

<sup>225</sup> This assumes that registration is sometimes cost-effective—that, for some offerings, the benefits of registration outweigh its costs. Some authors have questioned whether *any* registration requirement is

Assume that, once the size of an ordinary offering to unsophisticated investors reaches \$5 million, registration is economically justified on a cost-benefit basis.<sup>226</sup> This is consistent with the current \$5 million maximum in the small offering exemptions. If the integration doctrine and the related aggregation limits were abolished, the issuer could sell \$1 million worth of securities pursuant to Rule 504, \$5 million pursuant to Rule 505 and \$5 million pursuant to Regulation A. The total offering amount would be \$11 million, well above the amount at which registration makes sense.<sup>227</sup> Thus, if the issuer is free to combine exemptions without limit, offerings that should be registered will be exempted. To return to the currency reporting example,<sup>228</sup> a person might leave the country with four quarters, ten dimes, twenty nickels, and a hundred pennies, a total of four dollars. Because the four quarters are exempt under Rule 1, the ten dimes are exempt under Rule 2, the twenty nickels are exempt under Rule 3, and the one hundred pennies are exempt under Rule 4, no reporting would be required, even though the total amount far exceeds the amount at which currency reporting is cost-effective.

## V. RESOLVING THE DILEMMA: A WEIGHTED EXEMPTION SYSTEM

It is necessary to rethink the transaction exemptions to develop a system that allows issuers to use multiple exemptions where appropriate but retains the registration requirement when it is cost-effective—a system, in other words, that is efficient, but not subject to manipulation. The answer lies in a weighted exemption system. An issuer could use multiple exemptions for a single offering, subject to an overall dollar amount limit. In calculating whether an issuer's total sales fall within that limit, sales pursuant to each exemption would be weighted based on the amount of investor protection the particular

---

economically justified. See, e.g., Henry G. Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in WALL STREET IN TRANSITION THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY 21 (Henry G. Manne & Ezra Solomon eds., 1974); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964). For purposes of this Article, I accept the conventional wisdom that the benefits of registering non-exempted offerings exceed the costs. If not, the solution is not to abolish the integration doctrine, but to eliminate the Securities Act registration requirement.

<sup>226</sup> That is, the benefits of registration are greater than the costs and the net benefit of registration is greater than the net benefit of any of the exemptions.

<sup>227</sup> Even if the aggregation limits were retained, a single issuer could still sell \$5 million of securities pursuant to Rule 505, followed by another \$5 million pursuant to Regulation A. The Rule 504 aggregate offering price limit is only reduced by the amount of prior and concurrent sales, 17 C.F.R. § 230.505(b)(2)(i) (1999), and the Regulation A aggregate offering price limit is only reduced by the amount of prior Regulation A sales. *Id.* § 230.251(b).

<sup>228</sup> See *supra* Part IV.B.

exemption provides. Sales pursuant to Rule 504 would count more towards the overall limit than Regulation A sales, for example, because Rule 504 provides less investor protection.

### A. *Using Multiple Small Offering Exemptions*

Consider first the various small offering exemptions. Each small offering exemption provides a different level of investor protection. Rule 504, the least restrictive small offering exemption, also provides the least investor protection.<sup>229</sup> Small offering exemptions such as Rule 505 and Regulation A, on the other hand, have disclosure requirements and other limitations that provide greater protection to investors.<sup>230</sup>

The difference in the maximum dollar amounts of the small offering exemptions—\$5 million for Rule 505 and Regulation A but only \$1 million for Rule 504—reflects this difference. Because of the reduced investor protection, each dollar an investor invests in a Rule 504 offering is more at risk than a dollar invested in a Rule 505 or Regulation A offering. In Rule 505 and Regulation A offerings, the disclosure and information requirements provide investors with some, but not all, of the benefits registration would provide.<sup>231</sup> As a result, the marginal benefit of registration per dollar invested is greater for Rule 504 investors than for investors in Rule 505 or Regulation A offerings. Rule 505 and Regulation A offerees are already receiving more of the benefits that registration would provide, so the marginal gain per dollar of registering the offering would be less for them than for Rule 504 offerees.

This non-controversial insight is the key to developing a system that allows multiple exemptions for a single offering. If the marginal gains from registration are less for certain exemptions, then sales pursuant to those exemptions should contribute less to the overall cap above which registration is required. But how much less? How can we compare the marginal benefits of registration for the various exemptions? The answer lies in the offering amount limits of the exemptions.

The baseline for any rational system of exemptions from registration is some sort of *de minimis* exemption—an offering amount below which offerings should be completely and unconditionally exempted. Unconditional

---

<sup>229</sup> See *supra* notes 63-67 and accompanying text.

<sup>230</sup> See *supra* notes 68-80 and accompanying text.

<sup>231</sup> See *supra* notes 68-80 and accompanying text.

exemption would mean that no disclosure is mandated,<sup>232</sup> neither the SEC nor an alternative regulator reviews the offering, the manner of the offering is not restricted, and the investors are not required to have any special expertise or relationship to the issuer that would allow them to protect themselves. Even for an offering like this, there is some offering amount below which it is not cost-effective to require registration. If the total offering amount is ten dollars, for example, it would cost more to require registration than a total loss of the investment would cost investors. The cost of registration exceeds the benefit to investors, no matter how generously the benefits are measured. It makes sense neither to require registration nor to impose lesser conditions on the offering. As the dollar amount of such an unrestricted offering increases, the benefit of registering the offering increases at a faster rate than the cost;<sup>233</sup> eventually, the benefit of registration exceeds the cost.<sup>234</sup> The dollar amount below which registration is not cost-effective could be called the *baseline exemption amount*.

Until the 1999 amendments to Rule 504,<sup>235</sup> the baseline amount seemed to be \$1 million, the Rule 504 maximum. Rule 504 contained no disclosure requirements, the manner of the offering was not restricted, the exemption was not conditioned on review by the states or any other regulator, and the offering could be made to anyone.<sup>236</sup> If the \$1 million cap was correct, that must have been the offering amount at which the SEC believed the benefit of registering a previously unrestricted offering exceeded the cost. The \$1 million figure could have been wrong, but Rule 504 was rational only if the SEC believed \$1 million was the baseline exemption amount. Since the Rule 504 amendments, there is no unconditional federal exemption from registration.<sup>237</sup> Until the SEC develops a new *de minimis* exemption, Rule 504, the least restrictive exemption with the lowest offering amount, can serve as the baseline.

The initial rule is simply a restatement of Rule 504: if an issuer is using *only* the baseline Rule 504 exemption, registration should be required if the dollar amount of the offering exceeds \$1 million.

---

<sup>232</sup> This does not necessarily mean that issuers would provide no information to investors. Issuers have an economic incentive to provide disclosure to investors even when disclosure is not mandated. See FRANK H. EASTERBROOK & DANIEL R. FISCHL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 286-94 (1991).

<sup>233</sup> This is due to the high fixed costs of registration and the assumption that, for at least some offerings, registration is justified. See Bradford, *supra* note 12, at 614-18.

<sup>234</sup> See *supra* note 61.

<sup>235</sup> See *supra* text accompanying notes 65-67.

<sup>236</sup> See *supra* note 65 and accompanying text.

<sup>237</sup> See *supra* notes 66-67 and accompanying text.



Turn now to the Rule 505 and Regulation A exemptions. Because of the additional protection those exemptions provide investors,<sup>238</sup> the marginal gain from registration per dollar invested is less than for Rule 504 offerings. Or, to put it another way, the dollar amount of a Rule 505 or Regulation A offering must be greater before the benefit of registering that offering exceeds the cost. For those exemptions to be rational, the cut-off point, or the point at which registration provides a greater net benefit than the exemption, must be \$5 million. If the amount of the offering exceeds \$5 million under either of those exemptions, registration is required. We can state Rule 505 and Regulation A as follows: if an issuer is using *only* the Rule 505 exemption, registration should be required if the dollar amount of the offering exceeds \$5 million. Similarly, if an issuer is using *only* the Regulation A exemption, registration should be required if the dollar amount of the offering exceeds \$5 million.

We can restate the Rule 505 and Regulation A exemptions to make their offering amount limits more directly comparable to Rule 504:

1. If an issuer is using *only* the Rule 505 exemption, divide the dollar amount of the offering by 5. Call this the adjusted amount. If the adjusted amount exceeds \$1 million, registration is required.
2. If an issuer is using *only* the Regulation A exemption, divide the dollar amount of the offering by 5. Call this the adjusted amount. If the adjusted amount exceeds \$1 million, registration is required.

These restatements are equivalent to the current rules, but now state all three small offering exemptions in terms of a single \$1 million dollar cap. All that differs is how the amount is calculated. Offerings under Rule 505 and Regulation A only count one-fifth as much because, given the greater investor protection each provides (and assuming that the dollar amounts of the exemptions are correct), the marginal benefit of registration is only one-fifth as much.

Now that the three small offering exemptions are stated in comparable terms, it is easy to see how to combine them in a single offering. Since the adjusted amounts are based on the marginal benefits of registration for each type of offering, the benefit of registration exceeds its cost only when the total adjusted amount exceeds \$1 million, no matter the exemption under which the sales occur. Thus, an issuer should be able to spread an offering among the

---

<sup>238</sup> See *supra* notes 68-80 and accompanying text.

three exemptions as desired, as long as the total adjusted amount of the offering does not exceed \$1 million. To decide whether an issuer must register, we simply make the following calculations:<sup>239</sup>

1. Divide the dollar amounts of securities sold under Regulation A by 5.
2. Divide the dollar amounts of securities sold under Rule 505 by 5.
3. Add the Regulation A adjusted amount, the Rule 505 adjusted amount, and the Rule 504 dollar amount.
4. If the total adjusted amount is \$1 million or less,<sup>240</sup> the offering is exempt. If not, registration is required.

This becomes even simpler in a form:

---

#### WEIGHTED EXEMPTION CALCULATION

- |                                     |                 |
|-------------------------------------|-----------------|
| 1. Rule 504 Dollar Amount =         | \$ _____        |
| 2. Rule 505 Dollar Amount ÷ 5 =     | \$ _____        |
| 3. Regulation A Dollar Amount ÷ 5 = | \$ _____        |
| <b>TOTAL OF 1, 2, AND 3</b>         | <b>\$ _____</b> |

An exemption is available only if the TOTAL is \$1 million or less. Otherwise, registration is required.

---



---

<sup>239</sup> The mathematical calculation required is simple. No one can possibly object to the proposal on the ground of complexity, especially given the metaphysical meditation currently required to apply the integration doctrine.

<sup>240</sup> The aggregate offering price in Rule 504, Rule 505, and Regulation A is currently calculated using a one-year period. See 17 C.F.R. §§ 230.251(b), 230.504(b)(2), 230.505(b)(2)(i) (1999). The same time period could be used for my proposal.

There is, of course, nothing magical about either the one-year period or the \$1 million amount. The exemption amount could be \$500,000 over six months, \$2 million over one year, \$10 million over two years, or whatever amount/time combination one believed represented an appropriate tradeoff between the cost and benefit of registration. The SEC staff has itself proposed to change Regulation A to a \$5 million, six-month exemption. See *Task Force Report*, *supra* note 11, at 65-66. Changes like that require no significant changes to the weighted exemption proposal. If the Regulation A amount is changed as proposed, an appropriate adjustment can be made in calculating the contribution of Regulation A sales to the overall amount. If the Task Force's proposed amendment were adopted, Regulation A would allow sales of \$10 million per year. See

The weighted exemption system makes it easier to adjust the exemption amounts for inflation or other cost changes because all of the exemptions are linked to a single dollar amount. The rule establishing that amount could include an automatic annual adjustment pegged to some measure of inflation.<sup>241</sup> And having all exemptions tied to a single dollar cap allows easy adjustment for other external changes. If, for example, the cost of registration decreases due to technological changes or amendments to the registration requirement, the tradeoff between costs and benefits also changes.<sup>242</sup> The SEC can quickly adjust all of the exemptions to reflect the new tradeoff. And, even though the exemptions would be intertwined in a single combined system, changes to one exemption will not necessitate changes to the entire system. The SEC could, for example, increase the Regulation A dollar amount merely by changing its fractional weight in the weighted exemption system.

### *B. Dealing with the Sophisticated Offeree and Deference Exemptions*

The system explained above allows an issuer to use any combination of the small offering exemptions. If the weighted exemption system only went this far, it would be a tremendous improvement over the existing system. But how do the sophisticated offeree and deference exemptions fit into this proposed framework? The SEC could refuse to allow the sophisticated offeree and deference exemptions to be combined with small offering exemptions. Or the SEC could incorporate these other exemptions into the weighted exemption system, assigning each of them appropriate fractional weights. However, the approach most consistent with the current structure of the sophisticated offeree exemptions and their underlying policies is not to count such sales within the base exemption amount at all: in effect, they should be given a zero weight. An issuer should be able to combine sophisticated offeree exemptions with other exemptions without limit.<sup>243</sup> Determining how to treat deference exemptions is a little more difficult. A case could be made for treating them like

---

*id.* Thus, each dollar of sales pursuant to Regulation A would count as 1/10 of a dollar for purposes of the overall cap.

<sup>241</sup> I have previously explained why the exemption amount ought to be adjusted for inflation. See Bradford, *supra* note 12, at 622.

<sup>242</sup> To take an extreme example, assume that someone develops a new technology that allows issuers to beam an easily accessible electronic prospectus into everyone's home at virtually no cost. This would lower the cost of making a registered offering, changing the cost-benefit calculation used to draw the line between registered and exempted offerings. If it wanted to, the SEC could require the registration of more offerings simply by adjusting the overall weighted exemption cap.

<sup>243</sup> This is a fairly drastic change to existing law, so it is worth repeating that it is not an essential element of the proposed weighted exemption system.

the small offering exemptions—assigning them a weight based on the amount of investor protection they provide. However, their current structure suggests that they should be assigned a zero weight and be used freely with other exemptions.

### 1. *Sophisticated Offeree Exemptions*

Consider first the sophisticated offeree exemptions. They are premised on the negligible benefit that registration provides sophisticated investors.<sup>244</sup> The law presumes that these investors can protect themselves; thus, registration simply is not worth the cost.<sup>245</sup> When sales to those sophisticated investors are combined with sales of the same security to unsophisticated investors, nothing changes with respect to the sophisticated investors. As to them, the cost of registration still exceeds the benefit. And the sales to the sophisticated offerees do not in any way increase the benefit of registration for the other purchasers. Each portion of the offering must stand or fall on its own; if registration is not justified for either offering alone (hence the exemptions), combining the two will not change the cost-benefit tradeoff enough to alter that conclusion.

The existing structure of the sophisticated offeree exemptions supports this conclusion. The dollar amount of the sophisticated offeree exemptions is generally unlimited.<sup>246</sup> If this makes sense, it must reflect a judgment that the total cost of registering an offering to sophisticated offerees *always* exceeds the total benefit, no matter how large the offering. But this is true only if the marginal cost of registration (per dollar of securities sold) always exceeds the

---

<sup>244</sup> See *supra* Part II.B.

<sup>245</sup> Howard Friedman argues convincingly that some of the individuals left unprotected by the sophisticated offeree exemptions *do* need additional protection. See Friedman, *supra* note 81, at 293. However, the response to Friedman's criticism lies in changes to the exemptions themselves or to other aspects of securities law, not in the integration doctrine.

<sup>246</sup> There are two exceptions. One is section 4(6) of the Securities Act, which limits the offering to the amount allowed in section 3(b) of the Act. 15 U.S.C. § 77d(6) (1994). However, section 4(6) is used little, if at all. See COX, *supra* note 55, at 425.

A second, more important, exception is the latest sophisticated offeree exemption, Regulation CE, which has a \$5 million limit. 17 C.F.R. § 230.1001(b) (1999). This limit is a result of previous statutory limits on the SEC's power, not of policy considerations. Regulation CE is a section 3(b) exemption, and \$5 million is the maximum allowed under section 3(b) of the Securities Act. See 15 U.S.C. § 77c(b) (1994); Exemption for Certain California Limited Issues, Securities Act Release No. 7185, 60 Fed. Reg. 35,638, at 35,639 (1995) (proposed June 27, 1995). The SEC now has greater exemptive authority under section 28 of the Securities Act but has not yet used that authority to increase any exemption amounts above \$5 million. See 15 U.S.C. § 77z (1994).

marginal benefit of registration.<sup>247</sup> If so, then adding a sophisticated offeree offering to any other offering cannot bolster the economic case for registration.<sup>248</sup>

## 2. Deference Exemptions

It is unclear how to treat the deference exemptions in a weighted exemption system. On the one hand, the deference exemptions, like the sophisticated offeree exemptions, have no offering amount limit.<sup>249</sup> As with the sophisticated offeree exemptions, this policy makes sense only if the total cost of registering a deference exemption offering always exceeds the total benefit, no matter how large the offering. If this is the case, then the marginal cost of registration for such an offering (per dollar of securities sold) exceeds the marginal benefit of registration, and adding a deference offering to any other offering cannot bolster the economic case for registration.<sup>250</sup> Under this view, securities sold in a deference offering should not count against the baseline exemption amount.

On the other hand, the economic rationale for the deference exemptions does not preclude marginal benefits from registration with the SEC. Registration with the SEC might produce benefits even when an alternative regulator is already providing some investor protection. The larger the offering, the greater the likelihood that this incremental benefit of registration exceeds the cost of registration. In that case, sales pursuant to deference exemptions should be assigned a fractional weight just like the small offering exemptions.

## VI. POTENTIAL PROBLEMS WITH THE WEIGHTED EXEMPTION APPROACH

Three features of the various transaction exemptions—solicitation restrictions, resale restrictions, and limits on the number of purchasers—require special examination. Resale restrictions and limits on the number of

---

<sup>247</sup> If the marginal benefit exceeded the marginal cost, then at some offering amount, the total benefit of registration would exceed the total cost, and registration should be required.

<sup>248</sup> See Bradford, *supra* note 12, at 658-64.

<sup>249</sup> See *supra* Part II.C.

<sup>250</sup> If anything, the existence of a deference (or sophisticated offeree) offering could *reduce* the benefit of registration to the other investors. The alternative regulator (or the sophisticated offerees) could force the issuer to produce additional information, and that additional information could spill over to the other investors. Furthermore, if the securities in the two offerings are similar and sold on similar terms, any fairness review the alternative regulator does would benefit the other investors as well.

purchasers can be incorporated into the proposed weighted exemption system without seriously affecting either the policies served by those restrictions or the utility of the weighted exemption system itself. However, restrictions on solicitation present a more serious challenge. If the solicitation restrictions are maintained, the weighted exemption system loses some, but not all, of its usefulness. The choice is between some liberalization of the general solicitation restrictions or a less helpful weighted exemption system retaining vestiges of the transactional approach.

#### A. *Restrictions on Solicitation*

Some of the exemptions restrict solicitation of investors. General solicitation and advertising are prohibited in most Regulation D offerings,<sup>251</sup> and Regulation A limits pre-filing solicitation<sup>252</sup> as well as post-filing written solicitation and advertising.<sup>253</sup> Rule 147 and sections 3(a)(11) and 4(2) of the Securities Act also effectively limit solicitation and advertising by requiring that all offerees, not just purchasers, fall within the limits of the exemption.<sup>254</sup>

Allowing an issuer to use multiple exemptions in combination for a single offering introduces a new wrinkle into the restrictions on solicitation. What happens when an issuer may sell pursuant to several exemptions, some of which restrict solicitation and some of which do not? Solicitation and advertising are not easily confined within a single exemption; they have spillover effects.

Assume, for example, that an issuer is using both Regulation A and Rule 505 of Regulation D in combination for a single offering. To generate interest in the offering, the issuer publishes a written test-the-waters advertisement of the type allowed by Regulation A.<sup>255</sup> That advertisement is inconsistent with the Rule 502(c) prohibition of general solicitation and general advertising.<sup>256</sup> Some of the Regulation D purchasers may have seen the advertisement; indeed, they may have been attracted to the issuer because of the advertisement. Does the Regulation A solicitation impermissibly taint the

---

<sup>251</sup> 17 C.F.R. § 230.502(c) (1999).

<sup>252</sup> *Id.* §§ 230.251(d)(1)(i), 230.254.

<sup>253</sup> *Id.* § 230.251(d)(ii),(iii).

<sup>254</sup> *Id.* § 230.147(d); 15 U.S.C. §§ 77c(a)(11), 77d(2) (1994).

<sup>255</sup> 17 C.F.R. § 230.254 (1999) (allowing the issuer to determine whether there is any interest in a possible securities offering).

<sup>256</sup> *Id.* § 230.502(c).

Regulation D portion of the offering and make it impossible to use the two exemptions together?<sup>257</sup>

If the answer to this question is yes, then the weighted exemption proposal loses some of its utility. Issuers would have to comply with the most restrictive limits on solicitation for the entire offering.<sup>258</sup> If the answer to this question is no, then an issuer could indirectly circumvent the solicitation restrictions in one exemption by soliciting pursuant to another exemption, and using the solicitation to generate interest in the offering as a whole.

If the restrictions on solicitation and the associated focus on offerees rather than purchasers were eliminated, this predicament would disappear. Such a move probably makes sense,<sup>259</sup> and, for a while, federal securities law seemed to be moving in that direction. In 1992, the SEC modified Regulation A's ban on pre-filing offers to allow issuers to "test the waters," and freed all Rule 504 offerings from the general solicitation ban.<sup>260</sup> In 1995, the SEC proposed to extend the test-the waters idea to registered initial public offerings.<sup>261</sup> At the same time, the SEC requested comment on whether the prohibition against general solicitation in Regulation D (then applicable only to Rule 505 and 506 offerings) should be revised or eliminated.<sup>262</sup> And, in 1998, the SEC's Aircraft Carrier proposal suggested eliminating restrictions on offers for larger reporting companies and significantly relaxing those restrictions for other companies making registered public offerings.<sup>263</sup> However, in 1999, the SEC reimposed the general solicitation/general advertising ban on Rule 504

---

<sup>257</sup> A similar problem arises in dealing with the exemptions that focus on offerees rather than on actual purchasers. Rule 147, for example, says that offers may be made only to persons resident in the state or territory in which the issuer resides. *Id.* § 230.147(d). If an issuer makes an offering under Rule 147 at the same time as, for example, a Rule 504 offering, do the out-of-state offerees in the Rule 504 portion of the offering contaminate the Rule 147 portion of the offering?

<sup>258</sup> A weighted exemption system would still have some value to issuers because they could still combine other aspects of the exemptions in a single offering, as long as they limited their solicitation.

<sup>259</sup> See Campbell, *supra* note 14, at 136-43 (urging elimination of the Regulation D general solicitation ban); Stuart R. Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. FLA. L. REV. 1, 25-32 (1986) (urging that the restrictions on solicitation be loosened); Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 126-29 (1989) (urging elimination of the Regulation D general solicitation ban).

<sup>260</sup> Small Business Initiatives, *supra* note 64, at 36,444-5.

<sup>261</sup> Solicitations of Interest Prior to an Initial Public Offering, Securities Act Release No. 7188, 60 Fed. Reg. 35,648 (1995). See generally Jeffrey A. Brill, "Testing the Waters"—The SEC'S Feet Go from Wet to Cold, 83 CORNELL L. REV. 464 (1998).

<sup>262</sup> Exemption for Certain California Limited Issues, *supra* note 246, at 35,641.

<sup>263</sup> Aircraft Carrier, *supra* note 5, at 67,210-16.

offerings, with some exceptions.<sup>264</sup> The test-the-waters idea for registered offerings has apparently been subsumed by the Aircraft Carrier, the SEC deferred action on (and probably implicitly rejected) the idea of eliminating the general solicitation ban from Regulation D,<sup>265</sup> and it remains to be seen whether any aircraft will ever fly from the Aircraft Carrier.<sup>266</sup> Thus, at this point, the prospect of eliminating the general solicitation restrictions is uncertain at best.

A possible solution to the solicitation problem is some sort of tracing requirement that would attempt to determine what types of solicitation each purchaser has been exposed to and limit that purchaser to an exemption that allows such a solicitation. For example, a person who saw a Regulation A test-the-waters advertisement could not be part of the Regulation D portion of an offering. However, it would be prohibitively expensive or even impossible to trace the solicitations to which a potential purchaser has been exposed, especially given the possibility of indirect exposure.<sup>267</sup> Thus, tracing is not a realistic alternative.

### *B. Restrictions on Resale*

Some of the exemptions, such as Regulation D and Rule 147, restrict resales.<sup>268</sup> Others, such as Regulation A, do not; purchasers in a Regulation A offering may freely resell the securities they purchase.<sup>269</sup> If an offering is sold pursuant to more than one exemption, some of the securities will be freely tradable while others will be subject to resale restrictions.

Unlike the general solicitation issue, the resale problem is neither novel nor inextricable. Under the existing system, an issuer may have outstanding identical securities, some of which are restricted and some of which are not. For example, if an issuer sells common stock in a registered public offering

---

<sup>264</sup> 17 C.F.R. § 230.504(b)(1) (1999); Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, 64 Fed. Reg. 11,090 (1999) (proposed March, 8, 1999).

<sup>265</sup> Exemption for Certain California Limited Issues, *supra* note 246, at 35,641 (deferring action on the proposal). The subsequent decision to extend the general solicitation prohibition to Rule 504 offerings hardly seems consistent with the general elimination of the requirement from Regulation D.

<sup>266</sup> See SEC Commissioner Isaac C. Hunt, Jr., Speech, Aircraft Carrier: The Commission Comes to a Fork in the Ocean (Nov. 5, 1998), available at <<http://www.sec.gov/news/speeches/spch224.htm>> (visited June 23, 1999) (SEC Commissioner expressing doubts about the proposals in the Aircraft Carrier).

<sup>267</sup> For example, Smith sees a test-the-waters advertisement and suggests that her friend Jones check out the company. The issuer then sells to Jones in the Regulation D portion of the offering.

<sup>268</sup> See *supra* Part III.A.1.

<sup>269</sup> See 17 C.F.R. §§ 230.251-230.263 (1999).



and, a year later, sells the same class of stock in a Rule 506 private offering, the registered stock may be freely resold, but the Rule 506 stock is subject to the resale restrictions in Rule 144. Because of the special resale restrictions applicable to an issuer's affiliates, it also is possible for resale restrictions on securities to vary even when those securities are sold simultaneously in the same offering. Non-affiliates who purchase securities in a Regulation A offering or a registered offering may freely resell those securities while affiliates who purchase in the same offering may not.<sup>270</sup>

As implied above, the problem of a single class of security being simultaneously restricted and not restricted is currently solved through tracing. Non-affiliates who purchase stock in a registered offering may resell;<sup>271</sup> non-affiliates who purchase the same stock in a Rule 506 offering may not.<sup>272</sup> The tracing solution would work equally well when multiple exemptions are used for a single offering. For example, purchasers who buy in the Regulation A part of the offering may freely resell, but those who purchase in the Regulation D part of the offering may not. Although such tracing is not always easy, the problem is no greater in a weighted exemption system than it is in the current system. Thus, varying resale restrictions are not a major obstacle to the adoption of my proposal.

### C. *Limits on the Number of Purchasers*

Rules 505 and 506 limit the number of purchasers to whom an issuer may sell.<sup>273</sup> None of the other exemptions limit the number of purchasers. The policy justification for the Rule 505 and 506 limits is unclear.<sup>274</sup> But, assuming those purchaser limits are retained, how should they be applied if an issuer combines a Rule 505 or 506 exemption with some other exemption in the same offering? Should the entire offering be limited to thirty-five purchasers, should only the Rule 505 or 506 portion of the offering be limited to thirty-five purchasers, or should the thirty-five-purchaser limit be adjusted pro rata in proportion to the size of the Rule 505-506 portion of the offering?

When applying Rule 505 or 506 to a portion of the offering, one option is to limit the entire offering, including the portion sold pursuant to other

---

<sup>270</sup> See *supra* Part III.A.1.

<sup>271</sup> Campbell, *supra* note 116, at 1349-50.

<sup>272</sup> 17 C.F.R. 230.502(d).

<sup>273</sup> *Id.* §§ 230.505(b)(2)(ii), 230.506(b)(2)(i) (1999). Certain purchasers, including all accredited investors, are excluded from the 35 purchaser limit. See *id.* § 230.501(e)(1).

<sup>274</sup> See Bradford, *supra* note 12, at 635-39.

exemptions, to a total of thirty-five purchasers. This option, however, is inconsistent with the whole concept of the weighted exemption proposal. The dollar amount available for each exemption is calculated based on the amount of investor protection provided by its requirements, and that includes the purchaser limits.<sup>275</sup> No additional limitations beyond those provided in the particular exemption are needed. Furthermore, unlike the case of restrictions on solicitation, there are no spillover effects associated with this option. Not applying the purchaser limit to other parts of the offering does not in any way allow the issuer to circumvent the limits in Rules 505 and 506. Any sales pursuant to the restrictions in those exemptions will still be subject to the thirty-five purchaser limit.

If it does not make sense to apply the purchaser limit to the entire offering, should the thirty-five purchaser limit at least be reduced proportionately? The thirty-five purchaser limit is calculated on the basis of an entire \$5 million offering. If the Rule 505 or 506 sales are for less than \$5 million and are only a portion of the offering, it seems sensible to adjust the thirty-five purchaser limit proportionately to account for this. For example, if the Rule 505 portion of the offering is only for \$1 million, one-fifth of the total dollar amount, the purchaser limit should only be seven, one-fifth of the total purchaser limit. This argument seems plausible on its face, but it is inconsistent with the current structure of Rules 505 and 506. An issuer may make a Rule 505 or 506 offering to thirty-five purchasers, whether the offering amount is \$500,000, \$1 million, \$5 million, or, in the case of Rule 506, an unlimited amount. Whatever the purpose of the thirty-five purchaser limit, that purpose does not seem to depend on the size of the offering. Thus, the best solution is to continue to apply the full thirty-five purchaser limit, but only to the Rule 505 or 506 portions of the offering.<sup>276</sup>

## CONCLUSION

It is time to free the Securities Act registration exemptions from their transactional underpinnings. The integration doctrine and the complex system of metaphysics, safe harbors, and informal interpretations that keep the system (barely) alive should be abolished, and replaced with the weighted exemption system proposed in this Article. A weighted exemption system would fulfill

---

<sup>275</sup> See *supra* Part V.A.

<sup>276</sup> Since Rule 506 has no maximum dollar amount, it is difficult to see how its 35 purchaser limit could be proportionately adjusted to the dollar amount of the offering in any case.

all of the goals of the current system at a substantially lower cost to issuers, the SEC, and the investing public.